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CPA's guide to retirement plans for small businesses

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The CPA's Guide to
**RETIREMENT
PLANS**
FOR
**SMALL
BUSINESSES**

Gary S. Lesser, Editor

Kevin J. Donovan

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1 2 3 4 5 6 7 8 9 0 PP 0 9 8 7 6 5 4

ISBN 0-87051-601-9

Acknowledgments

The CPA's Guide to Retirement Plans for Small Businesses is the product of the hard work, insight, and dedication of many people, without which this book would not be possible. I would like to thank Kevin J. Donovan, Peter J. Gulia, Gregory Kolojeski; Marjorie R. Martin, Bruce McNeil, Stephen Mogila, Cherie O'Neil, and Lawrence "Larry" C. Starr for their skill and assistance in the writing of this book. All are accomplished experts in their fields. Their depth of knowledge of the subject matter was always refreshing and their thoroughness greatly appreciated.

I wish to express my great appreciation and deep gratitude to Martin Censor for his expertise in managing the editorial effort, and to the rest of the professional staff at the AICPA for making this book a reality.

I also thank Mac Brown, CPA; Benjamin Botwick, CPA; Susan D. Diehl; Alex R. DiMuro, CPA; Richard Epstein, CPA; Robert Garrels, CPA; Robert S. Keebler, CPA, MST; John J. Koresko, Esq., CPA; Robert Lipshutz, CPA; Barry Picker, CPA; David W. Powell, Esq., CPA; Christine P. Roberts, Esq.; Sal L. Tripodi, Esq., for their ongoing support and their assistance whenever called upon.

Thanks also to Lady Lucy of Canterbury Tails, Amber the Twerp, Butch the Beast Slayer, Simon the Magnificent, Abi-2, and Hi-Ho Silver Zorro, for their astute feline conversation, companionship, warmth, and, least of all, their occasional assistance in typing and editing. Special thanks to Gracie for her security services and for protecting the manuscript during its preparation.

Gary S. Lesser
June 2004

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Preface

In addition to providing information on qualified and tax sanctioned plans in general, this book focuses on aspects of plan design for the smaller business owner. In addition, numerous chapters are devoted to other issues that the practitioner may have a need to understand. Although many issues are beyond the scope of this book, it is the authors' intention to provide a generalized understanding of many of the issues that have an impact on plan design and plan operation, including:

- SEP, SARSEP, and SIMPLE plans
- Profit-sharing plans
- Defined-contribution pension plans
- 401(k) plans
- Defined-benefit plans
- Fully insured IRC Section 412(i) plans
- EPCRS, VFPC, and DFVC
- Plan distributions
- Rollovers and portability
- State taxation
- Beneficiary designations
- Form 5500 filing requirements
- ERISA
- USERRA
- Nonqualified plans
- Plan administration and fiduciary issues
- Plan asset investment issues
- IRS, PBGC, SEC, and DOL issues and investigations
- Plan reporting and disclosure requirements
- Participation, vesting, and funding issues
- The use of “rabbi” and “secular” trusts

The material presented in this book, however, is not intended to be a complete examination of the area and will not, in and of itself, equip practitioners to design and administer these plans on their own. The text is not intended to

replace or circumvent the need to retain competent legal advice, plan advisers, consultants, and/or administrators, or to circumvent the procedures for obtaining rulings and technical advice.

Retirement Terminology

Many areas of the law, particularly tax law, have their own language. The retirement planning area is no exception. Many terms-of-art have particular, and often peculiar, meanings that may not be apparent. It is for this reason that the authors have gone to great lengths to define and explain terms such as:

- Highly compensated employees
- Key employee
- Accrued benefit
- Administrator
- Beneficiary
- Employee
- Employer
- Fiduciary
- Hybrid plans
- Normal retirement age
- Participant
- Plan sponsor
- Plan year

Plan Updates, Review, and Maintenance

Initially, a company retirement plan may be updated periodically, as implementation proceeds. Once the plan is in motion, and all parties are satisfied with its progress, the plan must be reviewed at least annually, and updated as necessary. The practitioner must work closely with the client in order to make sound business and personal decisions.

Clients need guidance more than ever, given the combination of never-ending tax reform, the Internal Revenue Code's significant and complex changes, and the market volatility experienced over the past few years. Practitioners who provide this level of planning and review will help clients by:

- Making annual assessments of their retirement plans.
- Identifying weaknesses and recommending solutions.
- Educating clients about the process.

- Identifying ways to mitigate tax liability.
- Analyzing clients' needs and goals.
- Ensuring that clients' objectives are being achieved.

Practice Pointer: Throughout the text, we have provided you with numerous “Practice Pointers,” “Notes” and “Cautions.” These paragraphs spotlight areas in which you will interact with your client and draw attention to actions, activities, or information that you should be aware of to ensure competent and comprehensive client service.

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Introduction

Simply stated, the best retirement plan is the one that comes closest to satisfying the needs and objectives of the client, the adopting employer. Matching those needs to the various types of available plans and the myriad possible plan designs is often more difficult than defining the employer's needs and objectives. The benefits and costs associated with establishing, maintaining, and terminating the plan, and the life of the plan must all be considered. The motivation of the employees and the demographics of an employer may also be relevant factors in choosing the right plan. (See Appendix A, "Plan Feature Comparison Charts," for plan comparison and other useful charts. Appendix C, "Employee Benefits Limits," provides a table of indexed employee benefit limits for several years and estimates of the 2005 limits.)

For example, a simplified employee pension plan (SEP) program can compare favorably with a qualified plan even though fully vested SEP contributions would generally be made for transient employees with *three* or more years of service. A qualified plan's shorter eligibility requirement (generally, a service requirement of one year and 1,000 hours) *may* result in contributions having to be made or allocated to more employees. Although the qualified plan would most likely have a vesting schedule applied to employer-derived accrued benefits or account balances, it is applied to an additional two years of contributions made by the employer. The plan that offers the least employee cost at all points along an employee's employment time line can be determined only after:

- Considering many factors, such as potential growth of business, employee turnover, age, whether employed on the last day of the plan year, worked at least 500 or 1,000 hours, work patterns, and so on.
- Analyzing a group's eligibility to participate initially and then to receive contributions, and the extent to which those contributions will be vested upon an employee's termination of service.

Designing the Best Plan

The right plan can be selected by design, but the decision often involves the elimination of unsuitable plan types followed by the selection and design of the best plan from those that remain. For example, an employer that is unable to commit to a contribution level would not ordinarily adopt a pension plan. A 401(k) plan would not be suitable for a smaller business owner if non-highly compensated employees (NHCEs) choose not to make elective contributions. A SEP may be more suitable for a smaller business owner if there is high turnover in early years. It is generally better not to make a contribution for an employee than to rely on a vesting schedule or forfeiture provision.

Nonqualified deferred compensation plans should also be considered. In some cases, a nonqualified deferred compensation plan may be more appropriate in satisfying an employer's needs and objective. See Chapter 24, "Missing Participants, Beneficiaries, and Alternate Payees."

The funding of plan benefits is generally accomplished by investing in securities, as opposed to or in addition to life insurance, guaranteed investment contracts, annuities, and real estate. If an individual provides advice on such matters, they may have to be registered as an investment adviser.¹ If life insurance is purchased in a qualified plan, numerous tax and nontax issues also need to be considered.

In addition to providing information on qualified and tax sanctioned plans in general, this book focuses on aspects of plan design for the smaller business owner. In addition, numerous chapters are devoted to other issues that the practitioner may need to understand. Although many issues are beyond the scope of this book, it is the authors' intention to provide a generalized understanding of many of the issues that have an effect upon plan design and general operation of a plan.

The design of cross-tested plans is both an art and a science. The enormous complexity of the Internal Revenue Service (IRS) regulations in this area provides both opportunities and pitfalls for the practitioner. The need to have competent assistance on an initial and ongoing basis cannot be overemphasized. This is not an area in which the intelligent practitioner can afford to go it alone. The risk of mistakes being made is high and the penalty can be catastrophic, for both the client and the practitioner.

The material presented in this book is far from a complete examination of this area and will not, in and of itself, equip practitioners to design and administer these plans on their own. It is a wise individual who knows his or her limitations and calls in the artillery if appropriate. This book is not intended to replace or circumvent the need to retain *competent* legal advice, plan advisers, consultants, and/or administrators, or circumvent the procedures for obtaining ruling and technical advice.

¹ See Investment Advisers Act of 1940, Section 202(A)(11). See especially, Securities and Exchange Commission Release No. IA-1092, Part II(A)(1) (Oct. 8, 1987), penultimate sentence.

Definitions

Many of the terms used throughout this book have special meanings, as given in the following alphabetical list. Note, especially, the definitions for frequently used terms, including *highly compensated employee (HCE)* and *key employee*. For some terms, the definitions include commentary and examples.

Accrued Benefit

The meaning of the term *accrued benefit* is determined by the type of plan, as follows:

1. In a traditional *defined-benefit plan*, the individual's accrued benefit determined under the plan is generally expressed in the form of an annual benefit commencing at normal retirement age. Thus, the accrued benefit is the portion of an employee's normal retirement benefit that he or she has earned at a given point in his or her career.

Example. For example, if an employee enters a 1-percent final average pay plan at age 30, works until age 40, and earns average monthly pay of \$2,000, that employee's accrued benefit might be \$200 ($1\% \times \$2,000 \times 10$ years). If the same employee works until age 55 and his or her average monthly pay increases to \$3,000, the accrued benefit would increase to \$750 ($1\% \times \$3,000 \times 25$ years).

2. In an *individual account plan*, the balance of the individual's account is the accrued benefit. A *defined-contribution plan* is an individual account plan. The following example is based on such a plan:

Example. Aggregate contributions allocated to Kitty's qualified plan profit-sharing account totaled \$300,000, and the account currently has a fair-market value (FMV) of \$200,000. The account is 50-percent vested. Kitty's accrued benefit is \$200,000 (the value of her accounts under the plan); her vested accrued benefit is \$100,000 ($\$200,000 \times .50$).

3. Under a *cash-balance* or *pension equity plan*, the accrued benefit is the employee's account balance. The following is an example:

Example. An employee receives an allocation equal to 5 percent of pay each year he or she works, and the employee's account is credited with interest at 5 percent, compounded annually, until it is paid.

Actuarially Equivalent

Benefits payable at different times or in different forms are actuarially equivalent if they are of equal value, based on certain assumptions. The plan specifies the assumptions that are used to calculate actuarially equivalent benefits. The two assumptions most often used to compare the value of one

benefit to another are interest (which is used to measure the value of receiving a payment earlier instead of later) and mortality (which is used to measure the probability that the recipient will live to receive a given payment).

Administrator

The *administrator* is the person specifically so designated by the terms of the instrument under which the plan is operated; if an administrator is not so designated, the plan sponsor, or in the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person in accordance with Department of Labor (DOL) regulations.

Beneficiary

The *beneficiary* is a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder. See Chapter 20, "Beneficiary Designations."

Cash-Balance Plan

A *cash-balance plan* is a defined-benefit plan that defines an employee's benefit as the amount credited to an account. The account receives allocations (usually expressed as a percentage of pay) as the employee works. The account is also credited with interest adjustments until it is paid to the employee.

Defined-Benefit Plan

The term *defined-benefit plan* means a pension plan other than an individual account plan. Nevertheless, a pension plan, which is not an individual account plan and provides a benefit derived from employer contributions based partly on the balance of the separate account of a participant, is treated as an individual account plan to the extent benefits are based upon the separate account of a participant, and as a defined-benefit plan with respect to the remaining portion of benefits under the plan.

Defined-Contribution Plan

The term *defined-contribution* (or *individual account plan*) means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account; and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

Employee

The term *employee* means any individual employed by an employer, and includes an individual who is a self-employed individual for the taxable year.²

Employee Pension-Benefit Plan or Pension Plan

The terms *employee pension-benefit plan* or *pension plan* mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both. Such a plan is further defined by the extent to which, by express terms, or as a result of surrounding circumstances, such plan, fund, or program provides retirement income to employees, or results in a deferral of income by employees for periods extending to the termination of covered employment or beyond regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan. This is the Employee Retirement Income Security Act of 1974 (ERISA) definition which does not distinguish between plan types. Thus, under ERISA, a profit-sharing or SEP plan may be a *pension plan*. Except as necessary, the more familiar terms (money purchase, profit sharing, and so on) are used in this book.

Employer

The term *employer* means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.

Excess-Benefit Plan

The term *excess-benefit plan* means a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by Internal Revenue Code (IRC) Section 415.

Fiduciary

A person is a *fiduciary* with respect to a plan to the extent he or she can perform any of the following:

1. Exercise any discretionary authority or discretionary control respecting the management of such plan or exercise any authority or control respecting the management or disposition of its assets.
2. Render investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or assume any authority or responsibility to do so.

² IRC Section 401(c)(1)(A).

3. Assume any discretionary authority or discretionary responsibility in the administration of such plan. There are exceptions for investment companies and investment managers in which money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 (i.e., a mutual fund).

Highly Compensated Employee

For plan years beginning after 1996, a *highly compensated employee* (HCE) is either of the following:³

1. A 5-percent owner at any time during the current or preceding year
2. An individual who had compensation from the employer exceeding \$90,000 (the 2003 and 2004 limits) for the preceding year and was in the top-paid group

The employer may elect to limit highly compensated treatment for a year to employees who were in the top-paid group of employees for that year (see the following discussion). Any employee who is not a highly compensated employee is a nonhighly compensated employee (NHCE).

The applicable dollar amount (\$90,000) for a particular plan year (current year) or look-back year (i.e., preceding year) is the dollar amount for the calendar year in which the plan year or look-back year begins. Compensation, for this purpose, is the compensation received by the employee from the employer for the year, including elective or salary-reduction contributions to a cafeteria plan, cash or deferred arrangement, or tax-sheltered annuity.⁴ The rule requiring the highest paid officer to be treated as an HCE was repealed for plan years beginning after 1996.

In general, the top 20 percent of employees, ranked by compensation paid during a given year, are considered members of the top-paid group once the top-paid group election is made or once the SEP document makes the election automatic.⁵ An employer may make a top-paid group election in its plan document. Once such an election is made, it will apply to all future years unless changed by the employer. Furthermore, if such an election is made, only 5-percent owners and employees in the top-paid group are considered HCEs.⁶ An employer should keep track of whether the top-paid group election applies and, if so, to which years the election applies for purposes of making amendments in the future.

³ IRC Section 416(i)(1)(B)(i).

⁴ Temp. Treas. Reg. Section 1.414(q)-1T, Q&A-3(c)(1), Q&A-13.

⁵ IRC Section 414(g)(3).

⁶ IRS Notices 97-45 (1997-2 CB 296), 98-1 (1998-1 CB 610).

Hybrid Plan

A plan that defines an employee's accrued benefit as a single sum is sometimes called a *hybrid defined-benefit plan*, since it combines the appearance of a defined-contribution plan with the security of a defined-benefit plan.

A *cash-balance plan* is a type of hybrid defined-benefit plan. Another type of hybrid defined-benefit plan is a *pension equity plan*, which accumulates pension credits and applies them to an employee's pay to calculate a single-sum benefit.

A hybrid defined-benefit plan must comply with the same requirements that apply to other defined-benefit plans, including the rules that govern vesting, funding, and payment of benefits. All hybrid defined-benefit plans are required by law to offer annuities. If an employee is married, a hybrid plan automatically pays the employee's retirement benefit as an annuity for the joint lives of the employee and his or her spouse, unless the employee elects another form of payment and the spouse consents.

Target-benefit plans, in which the actual pension is based on the amount in the participant's account, are treated as defined-contribution plans. Hybrid plans, which are part target and part defined benefit, are treated as defined contribution to the extent that benefits are based on the individual account.

Key Employee

For plan years beginning after 2001, an employee is considered a *key employee* if, during the plan year, he or she was one of the following:

- An officer with compensation in excess of \$130,000, adjusted for cost-of-living adjustments (COLAs) in \$5,000 increments
- An owner of more than 5 percent
- A more than 1-percent owner with compensation in excess of \$150,000

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) eliminated the four-year look-back and the top-10 owner rules. The family ownership attribution rules under IRC Section 318,⁷ however, apply in determining whether an individual is a more than 5-percent owner of the employer for purposes of these rules.⁸ There is no *age 21* rule or exception under the IRC Section 318 attribution rules. This issue is more fully discussed in Chapter 2, "Simplified Employee Pension Plans — SEP and SARSEP."

⁷ See, S. Derrin Watson, "Who's The Employer," a guide to employee and aggregation issues affecting qualified plans and SEPs, Qs 14:1-14:14 (3rd Ed, 2003) at <http://www.employerbook.com/WTE3/>.

⁸ IRC Sections 408(k)(6)(G); 416(i)(1)(A) and (B).

Nonforfeitable

The term *nonforfeitable* when used with respect to a pension benefit or right means a claim obtained by a participant or his beneficiary to that part of an immediate or deferred benefit under a pension plan which arises from the participant's service, which is unconditional, and which is legally enforceable against the plan.

Normal Retirement Age

The term *normal retirement age* means the earlier of the time a plan participant attains normal retirement age under the plan, or the later of the time a plan participant attains age 65, or the fifth anniversary of the time a plan participant commenced participation in the plan.

Normal Retirement Benefit

The term *normal retirement benefit* means the greater of the early retirement benefit under the plan, or the benefit under the plan commencing at normal retirement age. The normal retirement benefit is determined without regard to medical benefits, and most disability benefits.

Participant

The term *participant* means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

Plan Sponsor

The term *plan sponsor* means the employer in the case of an employee benefit plan established or maintained by a single employer, the employee organization in the case of a plan established or maintained by an employee organization, or in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

Plan Year

The terms *plan year* and *fiscal year* of the plan mean, with respect to a plan, the calendar, policy, or fiscal year on which the records of the plan are kept.

Top-Heavy Plan

A smaller business owner is not likely to establish a plan that is not top heavy. A plan that is intended to be funded solely with elective contributions

may be top heavy and then require additional employer-derived contributions. A plan is top heavy when it primarily benefits key employees.⁹

A qualified defined-contribution plan or SEP that primarily benefits key employees as of the determination date is top heavy and becomes subject to the top-heavy rules of the IRC. A defined-contribution plan is top heavy when it benefits key employees when 60 percent or more of the aggregate account balances under the plan as of the determination date belong to key employees.¹⁰

Special rules allow an employer to determine whether a SEP or SARSEP arrangement is top heavy for any plan year by taking into account aggregate contributions rather than by taking into account aggregate account balances of all employees.¹¹

Determination Date

Generally, the determination date for determining whether a plan is top heavy is the last day of the preceding plan year. In the case of the first plan year of any plan, the determination date is the last day of that plan year; however, contributions made after the determination date that are allocated as of a date in that first plan year are not considered.¹² When calculating a participant's account balance for the purpose of determining whether a plan is top heavy, the account balance is increased for distributions made to the participant within the five-year period (which, after 2001, is generally reduced to a one-year look-back period) ending on the determination date.¹³ The five-year period is retained unless the distribution is made because of severance from employment, death, or disability.

When a qualified plan or SEP is top heavy, the employer must make a minimum contribution for each eligible nonkey employee that is equal to the lesser of the following:

1. Three percent of each eligible nonkey employee's compensation
2. A percentage of each eligible nonkey employee's compensation equal to the percentage of compensation at which elective and nonelective contributions are made under the plan (and generally under any other plan maintained by the employer) for the year for the key employee for whom the percentage is the highest for the year¹⁴

⁹ Treas. Reg. Section 1.416-1, Q&A G-1.

¹⁰ IRC Section 416(g)(1)(A)(ii).

¹¹ IRC Section 416(i)(6)(B).

¹² IRC Section 416(g)(4)(C); Treas. Reg. Section 1.416-1(b), Q&A T-24.

¹³ IRC Sections 408(k)(1)(B), 416(g)(3).

¹⁴ IRC Sections 408(k)(1)(B), 416(b)(2).

Elective contributions may not be used to satisfy an employer's top-heavy contribution requirement.¹⁵ In most cases, contributions made under other plans maintained by the same employer may also have to be considered.

Similar rules apply to defined-benefit plan, except that the determination is based on benefits rather than contributions, and minimum benefits must be provided to nonkey employees.

¹⁵ IRC Sections 408(k)(6)(D), 416(c)(2); Form 5305A-SEP, Top-Heavy Requirements, at 4; Prop Treas. Reg. Sections 1.401(k)-1(e)(7)(ii), 1.408-7(c)(2).

Chapter 2

Simplified Employee Pension Plans— SEP and SARSEP

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Simplified Employee Pension Plans—SEP and SARSEP

An employer may establish a simplified employee pension plan (SEP) under which it can contribute relatively large amounts to its employees' individual retirement accounts or annuities (IRAs). The employer (and, in some instances, the employees themselves) may make much larger contributions to the employees' IRAs under a SEP than employees could make to their IRAs under the normal IRA rules. For 2004, the maximum amount that can be contributed by an employer, including elective deferrals, is \$41,000 (\$44,000 with a catch-up contribution). All SEP contributions are made into traditional IRAs, commonly referred to as SEP IRAs, which are generally established by eligible employees. A SEP established before 1997 may include provisions allowing employees to make pretax (elective) contributions under the plan to reduce their compensation subject to federal (and, in some cases, state) income tax. Such a plan is referred to as a salary-reduction or elective SEP (SARSEP or grandfathered SARSEP).

EGTRRA Sunset

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made numerous changes to the rules regarding SEP and SARSEP. Although most of the provisions became effective in 2002, a number were effective in 2001. Most are phased in over several years, and some are set to expire sooner than others. The entire law will sunset after December 31, 2010. This means that if Congress does not act to extend these provisions, the law will revert back to the rules as they existed prior to EGTRRA. The Job Creation and Worker Assistance Act of 2002¹ (JCWAA) made technical corrections to

¹ Public Law 107-147.

EGTRRA, affecting SEP and SARSEP. All aspects of financial planning and retirement planning will have to consider the alternate possibility that the law may not be substantially extended or reenacted for years after 2010. Thus, lower pension limitations, higher federal income tax rates, and an estate tax could once again become a reality.

Caution: *Although EGTRRA generally increased deductible SEP contribution limits to 25 percent of the aggregate preplan compensation of participating employees, the amount that may be excluded from a participant's income (25 percent as a result of the JCWAA) is based on includable compensation. Catch-up contributions are separately deductible. As a consequence, SARSEP plan is generally designed around the exclusion limit rather than the higher deduction limit.²*

Establishing a SEP

An employer must establish its SEP and make its contributions to IRAs established by eligible employees. The SEP and the IRAs must be established by the due date of the employer's federal income tax return for the tax year to which the contribution is related (including extensions).³ A group trust may be established by an employer for holding the asset of the IRAs of its participating employees.⁴ In establishing a SEP, an employer may use the model SEP of the Internal Revenue Service (IRS), an IRS approved prototype SEP, or an individually designed SEP.

The term *employer* includes all related employers. *Related employers* are either members of an affiliated service group, a controlled group of corporations, or a trade or business under common control.⁵ All related employers should adopt the employer's SEP plan by affixing their signatures to the SEP plan agreement (and by adopting a written resolution if necessary).

An exception is provided, however, if an employer becomes or ceases to be related. The exception only applies during the transition period which begins on the date of the change in members of the group and ends on the last day of the first plan year beginning after the date of such change. In general, if the coverage requirements were satisfied before each change and coverage under the plan is not significantly changed during the transition period (other than change by reason of the change in members of the group), the participation rules will continue to be satisfied during the transition period.⁶

² IRC Sections 402(h)(2)(B), 404(h)(1)(B), 404(n).

³ IRC Section 404(h)(1)(B).

⁴ IRC Section 408(c).

⁵ IRC Section 414(b), 414(c).

⁶ IRC Section 410(b)(6)(C); see Rev. Rul. 2004-11 (2004-7___) IRB 480___ regarding the transition rule on a pension and profit-sharing plan following a sale of subsidiary stock to an unrelated employer.

IRS Model SEP

The simplest method by far for adopting a SEP is for the employer to adopt the IRS model plan, by executing IRS Form 5305-SEP, Simplified Employee Pension Individual Retirement Accounts Contribution Agreement, and/or model Form 5305A-SEP, Salary Reduction Simplified Employee Pension Individual Retirement Accounts Contribution Agreement. To adopt the IRS model SEP, an employer must meet all of the following requirements:

1. The employer must not maintain any other qualified retirement plan. (A terminated plan is not taken into account.)
2. IRAs must have been established for all eligible employees. An employer can require that employees establish IRAs for their own benefit; an employer can even establish IRAs on its employees' behalf if the employees refuse to do so for themselves or if any employee cannot be located.
3. The employer must not be a member of a controlled group of corporations; a trade, or business under common control; or an affiliated service group unless all eligible employees of all the members of the group, trade, or business participate in the SEP.
4. The employer must pay the cost of SEP (but not SARSEP) contributions.
5. Although an employer need not make a contribution for any particular year, for years in which it does contribute, the contribution percentage must be identical with respect to each employee. In other words, under the model forms, contributions may not be integrated with Social Security.
6. The employer does not use the services of a leased employee.
7. The employer does not have more than 25 employees eligible to participate in a SARSEP at any time during the prior calendar year (SARSEP only).
8. The employer is not a state or local government (SARSEP only).
9. The employer has any eligible employees whose taxable year is not the calendar year (prototype SARSEP only).
10. Compensation after reduction for elective contributions will be used for allocating employer contributions.⁷

Model SARSEP

To establish an IRS model SARSEP, an employer adopts IRS Form 5305A-SEP. An employer must also adopt IRS Form 5305-SEP in order to make contributions other than top-heavy contributions and employees' salary-reduction contributions. An employer's eligibility to adopt the IRS model SARSEP is

⁷ See Instructions, IRS Form 5305A-SEP, Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement, SEP Requirements,” page 3.

subject to the limitations described above for adopting Form 5305-SEP. If any key employee participates in a SARSEP, the employer must make a top-heavy minimum contribution but not more than 3 percent of the nonkey-employee's plan year compensation.⁸ Alternatively, an employer may make the required top-heavy contribution to all participants eligible to make elective contributions.

The model SEP forms (Form 5305-SEP and Form 5305A-SEP) were revised in March 2002. Employers were required to amend their existing model SEP and model SARSEP (for EGTRRA and the required minimum distribution regulations) and adopt the amended plans no later than December 31, 2002.

Note. The IRS appears to require an employer execution of the amended plan. A mere mailing of an amendment to existing forms to plan adopters may not be sufficient.⁹

Prototype SEP

The second method of establishing a SEP is for an employer to adopt a prototype SEP established by a bank or other permissible financial institution. The prototype plan document normally contains terms similar to those included in the IRS model SEP plan. An employer may normally rely on the IRS opinion letter obtained by the SEP's sponsoring organization, if the employer's contributions to the SEP, when combined with the employer's other retirement plan contributions, do not exceed the limitations of Internal Revenue Code (IRC or the Code) Section 415. No determination letter need (or can) be requested from the IRS by the employer. An employer may, however, request a ruling that its contributions do not exceed the IRC Section 415 limitations, whereby the employer maintains more than one SEP or maintains a qualified plan in addition to a SEP. A prototype SEP may allow for integration with Social Security, integration with noncalendar-year plans, and coordination with another plan.

Existing prototype SEP plans must be amended, approved, and adopted by the employer within 180 days after such plans receive IRS approval.¹⁰

⁸ Although not mentioned in the model Form 5305A-SEP, top-heavy contributions must be based on compensation that includes elective deferrals. See top-heavy rule of IRC Section 416(i)(1)(D) referring to the meaning, given the term under IRC Section 414(q)(4). In the author's opinion, the definition of compensation found in the model documents is, at best, unclear and could result in lower overall contributions than permitted in a prototype plan.

⁹ Rev. Proc. 2002-10 (2002-4 I.R.B. 401); but see, IRS Ann. 93-8 (1993-3 I.R.B. 61).

¹⁰ Rev. Proc. 2002-10 (2002-4 I.R.B. 401).

Individually Designed SEP

An employer may design its own SEP. As with qualified plans, an employer is not required to obtain a ruling from the IRS that the SEP satisfies the requirements of the Code, but employers frequently choose to do so.¹¹

Written Allocation Formula

Employer contributions must be determined under a definite written allocation formula that specifies the requirements an employee must satisfy to share in an allocation and the manner in which the amount allocated is computed.¹²

Vesting

Because employees' accounts are maintained in their own IRAs, employees are fully vested in all amounts contributed on their behalf.¹³ An employer cannot withdraw any amount from an IRA, even an amount made in excess of statutory limits.

Employee Eligibility to Participate

An employer has little leeway in choosing those employees to be covered under its SEP. The SEP must cover each employee who has:

1. Attained age 21 by the end of the plan year in which his or her participation began.
2. Has performed service for the employer during at least three of the immediately *preceding* five years.
3. Has received at least \$450 for 2004 (as indexed for inflation) in compensation from the employer for the current plan year.¹⁴

An employer may set less stringent requirements when completing the SEP adoption agreement. Although part-time employees are eligible to participate, the ability to have participation commence after three years of service may be a better alternative to the general one year-of-service requirement under a qualified plan.

¹¹ Rev. Proc. 83-36 (1983-1 C.B. 763).

¹² IRC Section 408(k)(5).

¹³ IRC Section 408(a)(4), 408(b)(4).

¹⁴ IRC Section 408(k)(2).

In making these determinations, all members of the employer's controlled group must be combined, as well as any members of an affiliated service group.¹⁵ Leased employees must be included as well.¹⁶ Union employees whose benefits have been the subject of good-faith collective bargaining, and nonresident aliens with no source of income in the United States, may, however, be excluded.¹⁷

Although leased employees must be included, statutory exclusions allow an employer, if it so chooses, to exclude from participation under its SEP plan the following employees:¹⁸

- Union employees whose benefits have been the subject of good-faith bargaining (and whose bargaining agreement does not require that they participate in the SEP)
- Nonresident aliens with no source of income in the United States

Example. Mary, age 30, works for an employer that maintains a SEP plan on a calendar-year basis. Mary earns more than \$450 in 2004. She performed service during 1999, 2000, and 2003, but performed no services during 2001 and 2002. Mary will share in any employer contribution made for the 2004 plan year even though she was not employed at the end of the 2004 plan year.

Compensation is not prorated in determining a participant's share in any contributions made by an employer. Service counts no matter how short and need not be in consecutive years. Owners must meet the same requirements specified in the plan that permit nonowner-employees to participate.

To provide participants who are more highly compensated with larger contributions, as a percentage of their compensation, contributions may be integrated with Social Security benefits on nearly the same basis as is permitted for qualified employer defined-contribution plans.¹⁹ Integration (permitted disparity) is more fully discussed in Chapter 7, "Permitted Disparity—Integration of Contributions."

Service

The term *service* means any work performed for an employer for any period of time, however short; it need not be continuous, and no special number of hours is required. The term is not defined in the Treasury Regulations.

Example. Claude's uncle owns a gas station that is open on Christmas. The business maintains a calendar-year SEP that provides for an employee to

¹⁵ IRC Sections 414(b), 414(c), 414(m), 414(n).

¹⁶ IRC Section 414(n)(3)(B).

¹⁷ IRC Section 408(k)(2).

¹⁸ IRC Section 408(k)(3)(B).

¹⁹ IRC Section 408(k)(3)(D).

perform service for three out of the five prior plan years to participate for the 2004 plan year. Claude pumped gas for his uncle's business on December in 2000, 2002, and 2003 and earned no compensation until he was formally hired in 2004 when he earned \$10,000 cleaning windshields and changing the air in tires. Claude quit his position in November 2004. Claude is eligible to participate in the SEP for the entire 2004 plan year if he attained age 21 or older on December 31, 2004 (regardless of whether he is employed on that date).

An owner must satisfy the plan's eligibility requirements if the owner is to participate. If a SEP plan is amended to increase the length of service requirement, discrimination is likely to result if highly compensated employee (HCE) participants could not have met the plan's eligibility requirements at the time the plan was originally adopted.²⁰

Caution: For SEP and SARSEP purposes, all employees of all employers that are related are treated as if employed by a single employer. Special complications arise if an employer maintains more than one SEP agreement and/or makes contributions to a qualified plan. Discriminatory allocations, differing eligibility conditions, or different investment alternatives available under the plan could cause the plan to run afoul of IRS rules.

The employer maintaining the plan is treated as the plan administrator for Employee Retirement Income Security Act of 1974 (ERISA) purposes.

Suitability

A SEP may be established by an employer of any size. The following types of business entities may establish a SEP:

- Corporations
- S corporations
- Sole proprietors (those who own the entire interest in an unincorporated trade or business operated for profit)
- Nonprofit and government entities (SARSEP are not available.)
- Limited liability companies (LLCs)
- Limited liability partnerships (LLPs)

General Limitations

There are no fewer than four limits that may apply to a SEP, eight limits if the plan is an SARSEP:

²⁰ See Rev. Ruls. 73-382 (1973-2 CD 134), 70-75 (1970-1 CB 94).

1. *The 25-percent participant exclusion limit.* Contributions allocated to an individual's SEP IRA may not exceed 25 percent (15 percent prior to 2002) of that participant's includable (i.e., taxable) compensation. In addition to this exclusion limit, a participant may exclude from gross income any catch-up contributions, but not other elective deferrals.²¹

Note. Catch-up contributions are treated as includable compensation for purposes of the 25 percent of includable compensation participant exclusion limit. Catch-up contributions are separately excludable from gross income.

Note. Catch-up elective contributions do not reduce the base on which the 25-percent participant exclusion limit is calculated.²²

2. *The 25-percent deduction limit.* Within limits, all SEP contributions are deductible. The 25-percent limit after 2003 (15 percent prior to 2002) is based on the aggregate compensation (up to \$205,000 for each participant) without reduction for elective deferrals.²³ In addition, elective and catch-up contributions are separately deductible by the employer beyond the 25-percent deduction limit. Contributions that exceed the deduction limit may be subject to a cumulative nondeductible excise tax penalty of 10 percent.²⁴

Caution: Contributions, although deductible, may be includable in a participant's gross income to the extent the amount allocated exceeds the participant's 25-percent exclusion allowance (see item 1) or other limit.

Currently, an employer may make a contribution on behalf of domestic and similar workers (other than the employer or a member of the employer's family). The employer, however, is not afforded a deduction because the contributions are not made in connection with a trade or business. As a result, the 10-percent excise tax on nondeductible contributions will most likely apply to such contributions. It should be noted that a savings incentive match plan for employees (SIMPLE) IRA is not subject to the 10-percent penalty tax on nondeductible contributions involving domestic and similar workers.

3. *The \$41,000 IRC Section 415 limit.* Contributions, other than catch-up contributions, may not exceed \$41,000 for 2004 (\$40,000 for 2003).²⁵ Contributions that exceed the IRC Section 415 dollar limit are neither deductible by the employer nor excludable from the participant's gross income. Thus, structurally, a SEP participant cannot receive more than \$44,000 (\$41,000 if under age 50 at any time during the calendar in which the plan year ends) for 2004.²⁶ The \$41,000 limit is reduced

²¹ IRC Section 402(h).

²² IRC Section 414(v)(3)(A).

²³ IRC Section 402(h).

²⁴ IRC Sections 4972(a), 4972(d)(1)(A).

²⁵ IRC Section 415(c)(1)(A).

²⁶ IRC Section 415(j). See, too, Treas. Reg. Section 1.414(v)-1(d)(1) regarding the treatment of catch-up contributions.

slightly when applied to an HCE participating in an integrated SEP. (See Chapter 7.)

4. *The 100 percent of compensation limit.* The total amount of compensation a participant allocates to an SARSEP may not exceed the participant's gross compensation.²⁷

The following limits only apply to a SEP with elective contribution provisions.

5. *The \$13,000 limit on excess deferrals.* A taxpayer's deferral limit under IRC Section 402(g) may not exceed \$13,000 under IRC Section 402(g).

Note. This limit is not reduced by elective contributions made under an eligible 457 plan unless the employers are treated as a single employer because they are controlled or affiliated as discussed above.

6. *The excess SEP contributions limit.* This applies to contributions that fail the 125-percent nondiscrimination test of IRC Section 408(k)(6)(iii), which would affect only HCEs.
7. *Disallowed deferrals.* This applies to deferrals failing the 50-percent participation rate requirement of IRC Section 408(k)(6)(A)(ii).
8. *The \$3,000 (for 2004) catch-up contribution limit.* Elective deferrals that exceed any applicable limit are treated as catch-up contributions. The catch-up contribution limit is \$3,000 (\$2,000 for 2003).²⁸

Except for nondeductible contributions (see item 2), all excesses are includable in gross income at different times and in different manners. Some excesses require notification (items 5, 6, and 7), others must satisfy IRS reporting requirements. Different types of excesses are treated in different manners. For example, items 6, 7, and 8 do not apply to the extent the 25-percent exclusion limit (item 1) is exceeded.

Note. In taxable years after 2001, employers are no longer required to establish a SEP in combination with a pension plan (such as a 10-percent money-purchase pension plan) to qualify for the 25-percent overall employer deduction limit.

Note. For taxable years beginning after 2001, EGTRRA allows for contributions to domestic and similar workers to continue to be made on a nondeductible basis, and the 10-percent excise tax on nondeductible contributions will not apply to a SIMPLE 401(k) or a SIMPLE IRA because such contributions are not a trade or business expense.²⁹ Unfortunately, similar provisions were not made for SEP or SARSEP that cover only a domestic or household

²⁷ IRC Section 415(c)(1)(A).

²⁸ IRC Sections 402(h)(2), 414(v)(3)(A); Treas. Reg. Section 1.414(v)-1(c)(1).

²⁹ IRC Section 4972(c)(6).

worker. Thus, nondeductible SEP contributions may be subject to the 10-percent excise tax.

Nondiscriminatory Coverage

In general, a SEP is considered discriminatory unless contributions bear a uniform relationship to the compensation of the employees covered.³⁰ In applying this rule, only the first \$205,000 in compensation may be considered for a plan year beginning in 2004 (\$200,000 for 2002). That amount is periodically adjusted for inflation.

Nondiscriminatory Contributions

Contributions to a SEP must not discriminate in favor of any HCE.³¹ For 2004, the term *highly compensated employee* (or *HCE*) means either of the following:

- An individual who was a 5-percent owner at any time during the current or preceding year, or
- An individual who had compensation from the employer exceeding \$90,000 for the preceding year. (The employer may elect for a year to limit this to a person who was in the top-paid group of employees for that year.)³²

The rule requiring the company's highest paid officer to be treated as an HCE was repealed for plan years beginning after 1996.

No Maximum Age Restrictions

There are no maximum age restrictions in a SEP. Eligible employees may participate in a SEP plan regardless of their age. Unlike contributions to a traditional IRA, SEP contributions may be made by the employer to the IRA of an eligible employee after he or she reaches age 70½. Even though SEP contributions may continue beyond age 70½, required minimum distributions (RMDs) must be made from the SEP IRA on a timely basis.

³⁰ IRC Section 408(k)(3)(C).

³¹ IRC Section 408(k)(3).

³² IRC Section 414(q).

Salary-Reduction Contribution

A SEP may include a salary-reduction feature, under which employees can choose to have contributions made from their pay to their IRAs, established under the SEP.³³ SARSEP were replaced by SIMPLE plans for years after 1996. Accordingly, no new salary-reduction SEP may be established, but existing ones are grandfathered under the new law. Elective deferrals are permitted only if the following conditions are met:

1. At least 50 percent of the employees eligible to participate choose to make elective deferrals for the plan year.³⁴
2. The employer had no more than 25 eligible employees (or employees who would have been required to be eligible if a SEP had been maintained) at any time during the preceding plan year.³⁵
3. The amount deferred each year by each eligible HCE, as a percentage of compensation, is no more than 125 percent of the average deferral percentage for all other eligible employees, determined separately.³⁶

Compensation in excess of \$205,000 for 2004 is not considered in figuring an employee's deferral percentage.³⁷

Example. Under a grandfathered SARSEP using Form 5305A-SEP, a company's nonhighly compensated employees (NHCEs) elect to reduce their compensation and contribute the noted percentages of their compensation, as follows:

NHCE	Compensation	Deferred Amount	Percentage Deferred
Alice	\$10,000	\$800	8%
Bruce	\$ 9,000	\$360	4%
Carol	\$ 8,000	\$320	4%
Drew	\$ 7,000	\$ 0	0%

The correct method for computing the percentage of compensation that each eligible HCE may elect to defer is to sum the NHCEs' individual percentages (i.e., determined separately):

$$\text{Average NHCE Deferral: } (8\% + 4\% + 4\% + 0\% = 16\%) \div 4 = 4\%$$

³³ IRC Section 408(k)(6).

³⁴ IRC Section 408(k)(6)(A)(ii).

³⁵ IRC Section 408(k)(6)(B).

³⁶ IRC Section 408(k)(6)(A)(iii).

³⁷ IRC Section 408(k)(6)(B)(ii).

This result, 4 percent, multiplied by 1.25, gives 5 percent, which may be deferred by each eligible HCE up to \$13,000, plus catch-up contributions for the 2004 plan year. On the other hand, it is incorrect to compute the total dollars deferred as a percentage of compensation. Such a computation would be

$$(\$800 + \$360 + \$320 + \$0) / (\$10,000 + \$9,000 + \$8,000 + \$7,000) = 4.35\%$$

This incorrect result, 4.35 percent, multiplied by 1.25% gives 5.44 percent.

NHCE Compensation Deferred Amount Percentage Deferred

Elective deferrals for nonkey employees may not be used to satisfy the minimum contribution top-heavy rules.³⁸

Salary-reduction contributions are limited to \$13,000 plus catch-up contributions for plan years ending in 2004. This limitation is indexed for cost-of-living adjustments (COLAs). The limit applies to (on the employer and individual level) the aggregate of salary-reduction contributions made to all plans permitting such contributions, including, for example, 401(k) plans.

Example. Moe, age 30, who has moonlighting income, establishes a SEP program for 2004. Moe also makes a \$8,000 salary-reduction contribution to an unrelated employer's 401(k) plan for 2004. The most Moe may contribute to the SARSEP is \$5,000 (\$13,000 annual limit reduced by the \$8,000 elective contribution).

Catch-Up Contributions

An individual is eligible to make a catch-up contribution to an SARSEP if the individual is treated as attaining age 50 at any time during the plan year. A calendar-year taxpayer who attains age 50 by the end of the employee's taxable year (December 31) is treated as having attained age 50 on January 1 of that year.

Elective deferrals in excess of an applicable limit are treated as catch-up contributions to the extent that elective deferrals do not exceed the catch-up contribution limit for the tax year reduced by elective deferrals previously treated as catch-up contributions for the tax year. For 2004, the catch-up contribution limit for an SARSEP is \$3,000 (\$1,500 in the case of a SIMPLE IRA).³⁹ Unless an individual also participates in an eligible governmental 457 plan, he or she is entitled to exclude from income only catch-up amounts that do not exceed \$3,000 in the aggregate for 2004.⁴⁰

The amount of elective deferrals in excess of an applicable limit is generally determined as of the end of a plan year by comparing the total elective de-

³⁸ IRC Section 408(k)(3).

³⁹ IRC Section 414(v)(2)(B).

⁴⁰ Treas. Reg. Section 1.414-1(g)(2).

ferrals for the plan year with the applicable limit for the plan year. For a limit that is determined on the basis of a year other than a plan year (such as the calendar-year limit on elective deferrals under IRC Section 401(a)(30)), the determination of whether elective deferrals are in excess of the applicable limit is made on the basis of such other year.⁴¹

Catch-up contributions are determined by reference to statutory limits, employer-provided limits, and the actual deferral percentage (ADP) limit, all of which are discussed in more detail in the following:

- *Statutory limits.* The Code includes statutory limits that pertain to elective deferrals or annual additions permitted to be made under a SARSEP without regard to IRC Section 414(v). Statutory limits include the requirement under IRC Section 401(a)(30) that the plan limit all elective deferrals within a calendar year under the plan and other plans (or contracts) maintained by members of a controlled group to the amount permitted under IRC Section 402(g) regarding elective contributions.⁴² The 25 percent of includable compensation exclusion limit is also a statutory limit.
- *Employer-provided limit.* An *employer-provided limit* is the limit placed on employees' elective deferrals under the terms of the plan. SARSEP do not generally contain plan limits on elective deferrals. Admittedly, some employers cap elective deferrals when they intend to make a top-heavy or other nonelective contribution to employees' accounts.
- *The ADP limit.* For purposes of the 125-percent deferral test in a SARSEP, regulations provide that any elective deferral for the plan year that is treated as a catch-up contribution, because it is in excess of a statutory limit or an employer-provided limit, be disregarded for purposes of calculating the participant's actual deferral ratio. That is, catch-up contributions are subtracted from the participant's elective deferrals for the plan year prior to determining the participant's actual deferral ratio. This subtraction applies without regard to whether the catch-up eligible participant is an HCE or an NHCE.⁴³

Catch-Up Rules

Catch-up contributions are not subject to otherwise applicable limits under a SEP. Thus, an elective deferral that is treated as a catch-up contribution is not subject to otherwise applicable limits under the SEP, and the plan would not be treated as failing otherwise applicable nondiscrimination requirements because of the catch-up contributions. Catch-up contributions would not be taken into account in applying the limits of certain sections of the IRC (e.g., IRC Sections 401(a)(30), 402(h), 404(h), 408(k), 408(p), 415, and 457) to other

⁴¹ Treas. Reg. Section 1.414(v)-1(c)(3).

⁴² IRC Section 408(k)(6)(A)(iv).

⁴³ Treas. Reg. Section 1.414(v)-1(d)(2).

contributions or benefits under the plan offering catch-up contributions or under any other plan of the employer.⁴⁴

Caution: *Because an amount treated as a catch-up contribution is not taken into account in calculating the ADP rate, the ADP rate may have to be recalculated if unanticipated catch-up amounts are determined to exist for any participating NHCE.*

Top-Heavy Considerations

Catch-up contributions with respect to the current plan year are not taken into account for purposes of IRC Section 416 regarding top-heavy contribution requirements. However, catch-up contributions for prior years are taken into account for purposes of IRC Section 416. Thus, catch-up contributions for prior years are included in the account balances that may be used in determining whether a plan is top heavy under IRC Section 416(g).⁴⁵

IRC Section 415 Limit Considerations

Catch-up elective contributions are also not taken into account in determining whether the 100 percent of compensation limit has been exceeded. Other limits, such as the 25 percent of includable compensation exclusion limit, are always lower than the 100 percent of compensation limit.⁴⁶

Catch-Up Contributions Deductibility

All elective contributions (including catch-up elective contributions) are deductible by the employer.⁴⁷

Salary-Reduction Limit

An employee may contribute as much as \$13,000 for 2004 by means of a salary-reduction agreement. If an individual participates in a SARSEP and attains age 50 by the end of the employee's taxable year, he or she may make additional elective deferrals up to an applicable dollar limit. That catch-up amount is in addition to the normal deferral limit for the applicable year. The maximum amount of the catch-up contributions is the lesser of the participant's compensation for the year or the applicable dollar amount.⁴⁸ The applicable dollar amounts for years beginning after 2004 are as follows:⁴⁹

⁴⁴ Treas. Reg. Section 1.414(v)-1(d).

⁴⁵ Treas. Reg. Section 1.414(v)-1(d)(2)(iv).

⁴⁶ IRC Section 414(v)(3)(A)(i).

⁴⁷ IRC Section 404(n).

⁴⁸ IRC Section 414(v); Treas. Reg. Section 1.414(v).

⁴⁹ IRC Section 402(g)(1). The \$15,000 elective deferral limit is to be increased for COLAs in increments of \$500 after 2006. IRC Section 402(g)(5).

Year	Increased Deferral Limit
2005	\$14,000
2006 or thereafter	\$15,000

Example. Herb, a calendar-year taxpayer, attains age 50 on November 3, 2004. Herb is a participant in a SARSEP with a plan year ending on June 30, 2004. He is eligible to make a catch-up contribution for 2004 because he is treated as having attained age 50 on January 1, 2004, which is within the plan year starting July 1, 2003, and his tax year begins after December 31, 2003.

Maximum Compensation Limits

EGTRRA increased the maximum compensation that can be considered on behalf of any participant in a SEP from \$150,000 (actually \$170,000 for 2001 because of COLAs) to \$200,000 for plan years beginning after 2001. The \$200,000 limit is to be increased for COLAs in increments of \$5,000. For 2004, the limit is \$205,000. Plan documents determine the actual definition of compensation that is to be used by the adopting employer for various purposes under the plan. SEP plans do not, however, define compensation for employer deduction or participant exclusion purposes.

After 2001, the definition of compensation for SEP (and SIMPLE) include an individual's net earnings that would be subject to taxes under the Self-Employment Compensation Act (SECA) but for the fact that the individual is covered by a religious exemption.⁵⁰ In addition, after 2001, the compensation received by a nonresident alien who is a regular member of a crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States is not considered U.S.-source income for purposes of a SEP (or any qualified retirement plan or SIMPLE IRA).⁵¹

Integration With Social Security

If a SEP is integrated with Social Security, the contribution percentage made with respect to compensation above a certain amount (the integration level) is higher than the percentage contributed on compensation below that point. The integration of SEP contributions with Social Security is more fully discussed in Chapter 7.

⁵⁰ IRC Sections 401(a)(17), 404(k), 408(l).

⁵¹ IRC Section 861(a)(3).

More Than One Plan

If the employer makes contributions to more than one SEP or to a qualified plan, a special limit called the *annual addition limit* applies. For 2004, that limit is equal to the *lesser of*:

- 100 percent of preplan compensation for the limitation year (i.e., without reduction for elective contributions and salary-reduction contributions to cafeteria plans)
- \$41,000 (including elective contributions, but not catch-up (maximum \$3,000) contributions for 2004)

Exclusion of Contributions by Employee

Generally, a SEP/SARSEP contribution for 2004 is not includable in an employee's gross income or treated as wages to the extent that the contributions do not exceed the lesser of (1) 25 percent of includable taxable compensation for the plan year without regard to the contributions or (2) \$41,000.⁵² Catch-up contributions are separately excludable from a participant's gross income up to \$3,000, the limit on catch-up contributions for 2004.⁵³

Example. Joan participates in her employer's elective SEP plan. She has Form W-2, Wage and Tax Statement, compensation of \$9,500 for 2004 after making a \$500 elective contribution. The 25-percent exclusion limit would be based on \$9,500. Thus, the sum of Joan's employer's contributions, including elective deferrals, cannot exceed \$2,375 ($\$9,500 \times .25$). Although the deduction limit is higher, specifically, \$3,000 [$(\$10,000 \times .25) + \500], amounts allocated to Joan in excess of \$2,375 would be includible in her gross income.

Example. Joe, age 50, participates in his employer's SARSEP. Joe's preplan compensation is \$100,000. He contributes \$16,000 of that amount to his SEP IRA of which \$3,000 is treated as an elective catch-up contribution. Joe's exclusion limit can be computed as follows:

$$\$100,000 - \$13,000 = \$87,000$$

$$\$87,000 \times .25 = \$21,750$$

The sum of \$21,750 and \$3,000 is \$24,750, the most that may be excluded from Joe's income when combined with any nonelective employer contributions.

⁵² IRC Section 402(h).

⁵³ IRC Section 414(v).

The maximum employer's contribution can be determined as follows:

Preplan compensation	\$100,000
Less elective contributions	–13,000
Exclusion compensation (IRC Section 402(h))	\$ 87,000
Exclusion percentage x .25	x .25
Maximum excludable contribution	\$21,750
Less total elective contribution	\$13,000
Maximum excludable employer contribution	\$8,750

Contribution Due Dates

SEP are permitted to be based on an employer's fiscal tax year or based on the calendar year. A business may deduct contributions to a SEP on its business tax return if the contribution to the SEP IRA is made *after* the business tax return is filed but *before* the due date of the return.⁵⁴

To be granted an extension of time to make a SEP contribution, a corporation must file Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, by the regular due date of its Form 1120 or Form 1120S. The automatic extension is six months. If the business is not taxed as a corporation, all owners should have their personal income tax returns extended to the date the contribution is to be made, or later. A partnership must file Form 8736, Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts, by the regular due date of its Form 1065, U.S. Partnership Return of Income. The automatic extension is three months.

Deduction Timing

For the purpose of claiming a deduction for its contribution, an employer may establish its plan on the basis of its business taxable year or on the basis of the calendar year. The plan must be based on the calendar year when an employer is using the IRS model Form 5305-SEP or Form 5305A-SEP to establish its SEP or SARSEP. Most prototype SEP allow for an employer to choose between maintaining its plan on the basis of its business taxable year or maintaining it on the basis of the calendar year.

⁵⁴ Rev. Rul. 84-18 (1984-1 C.B. 88). See also Ltr. Ruls. 8536085 (Jun. 14, 1985), 8628047 (Apr. 15, 1986), and 8611090 (Dec. 20, 1985) regarding post office cancellation date for IRA contributions and the Taxpayer's Bill of Rights.

Special rules apply to the timing of the deductibility of an employer's contribution when a SEP is not maintained on the basis of its business taxable year (or if the plan is amended to change the plan year⁵⁵). Within the prescribed limits, all SEP and SARSEP contributions are deductible by the employer if paid by the due date (including extensions) of the business tax return and made on account of that taxable year. Nonetheless, SARSEP contributions (which are plan assets) must be forwarded sooner to comply with Department of Labor (DOL) rules. (See Chapter 19, "Deadlines for Depositing Employer Contributions and Loan Repayments.")

The prorating of SEP contributions for a plan year between two taxable years is not permitted for deduction purposes. Contributions are deductible by the employer in accordance with the following rules:⁵⁶

1. In the case of a SEP maintained by a *calendar-year business* on a *calendar-year basis*, contributions are deductible for such *calendar year*.
2. Contributions made to SEP maintained on the basis of the *employer's taxable year* are deductible for such *taxable year*.
3. When a *fiscal-year business* maintains a SEP on a *calendar-year basis*, contributions are deductible for the fiscal taxable year that includes December 31.

SEP and Traditional IRA

Nothing in the law prohibits an employee from also using his or her IRA established under a SEP as a personal IRA. A particular financial institution may establish individual restrictions. An employee with compensation of at least \$3,000 (\$3,500 with catch-up contributions) may generally contribute an additional \$3,000 (\$3,500 with catch-up contributions) to his or her SEP IRA for 2002 and 2003, although the contribution may not be deductible because of the employee's participation in the SEP.

Withdrawals

A SEP may not prohibit employees from withdrawing amounts from their IRAs established or funded under the program.⁵⁷ Similarly, employer contributions to a SEP may not be conditioned on employees' agreeing not to withdraw those amounts.⁵⁸

⁵⁵ Special plan provisions are required to change SEP plan years. In general, the employee is to be treated as a participant in *both* the short-plan year and the new plan year if the employee was eligible to participate in either of those periods.

⁵⁶ IRC Section 404(h).

⁵⁷ IRC Section 408(k)(4).

⁵⁸ IRC Section 408(a)(3), 408(c).

Restricted Funds

Elective contributions made to a SARSEP may not be withdrawn or transferred to another IRA or SEP IRA until the earlier of:

1. The time a determination is made by the employer that the special 125-percent nondiscrimination test has been satisfied, or
2. March 15 following the close of the plan year.

Until such determination is made, any transfer or distribution from a SEP of restricted funds (salary-reduction contributions and income attributable to such contributions) is subject to tax and may be subject to the 10-percent premature distribution penalty regardless of whether an exception to the tax would otherwise apply.⁵⁹ Excess elective deferrals (amounts in excess of \$13,000 plus catch-up contributions for 2004) may be withdrawn before this time; however, they may not be rolled over or transferred to another IRA.

Note. It is not clear whether the restriction applies to all employees or just to HCEs. Any distribution, transfer, or rollover of the restricted funds before employer certification or before March 15 following the end of the plan year may be treated as an *other than* excess contribution, permitted to be withdrawn without penalty. The tax, if any, is reported on Form 5329.⁶⁰

Excess Contributions

The general rules that apply to excess contributions in traditional IRAs apply to participants in SEP IRAs. In general, an excess contribution made to a participant's SEP IRA may be corrected without the individual's having to pay a 6-percent penalty tax provided the amount is removed (adjusted for gain or loss) before the due date of the individual's federal income tax return (including extensions), and no deduction is taken for the contribution. If a taxpayer's return has been timely filed without withdrawing the excess contribution, the amount may still be withdrawn without penalty no later than six months after the due date of the tax return, *excluding* extensions. If the excess is withdrawn within this period, the participant must file an amended return with "Filed pursuant to Section 301.9100-2" written at the top of the amended tax return, report any related earnings on the amended return, and include an explanation of the withdrawal. Any other necessary changes should be made on the return (e.g., if the contribution was reported as an excess contribution on the original return, an amended Form 5329 should be included, reflecting

⁵⁹ IRC Section 408(d)(7)(A).

⁶⁰ Form 5329, Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs.

the fact that the withdrawn excess contributions are no longer treated as having been contributed).⁶¹

Top-Heavy Rules

The top-heavy rules for qualified employer retirement plans apply also to SEP. Instead of using aggregate account balances to determine whether an individually designed SEP plan is top heavy (as required with a qualified plan), an employer may elect to use annual contributions (presumably for all years). This means, for example, that if key employees' IRAs receive more than 60 percent of the aggregate employer contributions allocated to employees for all plan years, the employer must contribute to the IRAs of nonkey employees the *lesser of* either:

1. 3 percent of plan year compensation, or
2. The highest percentage of plan year compensation contributed to any key employee's IRA.

Prototype and model plans use the annual contribution method to determine whether the plan is top heavy.

Caution: *The IRS model SEP agreement, Form 5305A-SEP, is automatically deemed top heavy if any key employee makes an elective contribution. Because SEP generally require uniform contributions, these rules are important only for integrated SEP and SARSEP that are top heavy or (as is generally the case with the IRS model plan) deemed top heavy.*

Key Employee

The term *key employee* was modified by EGTRRA for 2002. For plan years beginning after 2001, an employee is considered a key employee if, during the plan year, he or she was one of the following:

- An officer with compensation in excess of \$130,000 (adjusted for COLAs in \$5,000 increments)
- An owner of more than 5 percent
- A more than 1-percent owner with compensation in excess of \$150,000

EGTRRA eliminated the four-year look-back and the top 10 owner rules. The family ownership attribution rules under IRC Section 318,⁶² however, apply in determining whether an individual is a more than 5-percent owner of

⁶¹ Treas. Reg. Section 301.9100-2; Instructions for Form 5329, "Specific Instructions," pt. III (2003).

⁶² See, S. Derrin Watson, "Who's The Employer," a guide to employee and aggregation issues affecting qualified plans and SEPs, Qs 14:1-14:14 (3rd Ed, 2003) at <http://www.employerbook.com/WTE3/>.

the employer for purposes of these rules.⁶³ For purposes of determining a plan's top-heavy status, the five-year look-back period applicable to distributions was one year, except for in-service distributions. Also, if an employee has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made, that employee's account balance is not taken into account for determining top-heavy status.⁶⁴

Caution: *There is no age-21 rule or exception under the IRC Section 318 attribution rules. Legally adopted children are treated as blood relatives.*⁶⁵

IRC Section 318 Attribution

An individual is deemed to own stock (or other ownership interests) held by his or her spouse unless they are divorced or legally separated under a decree of separate maintenance. Unlike the controlled group rules, there apparently is attribution between spouses even if there is an interlocutory decree of divorce, and even if the nonowning spouse is not involved in the business.⁶⁶

An individual is also deemed to own stock (or other ownership interests) held by his or her parents, children, and grandchildren.⁶⁷ Notice that there is attribution from grandchild to grandparent but not from grandparent to grandchild. There is no age-21 rule limiting the attribution of stock between parent and child. Adopted children are treated as blood relatives.⁶⁸ There is no double attribution under the family rules, although stock deemed to be owned under one of the other rules (such as attribution from trusts or options) can then be deemed to be owned by a family member.

Family Attribution

Example. The Robinson family members consist of Dad and Mom, a married couple, and their children (Brother and Sister), and Sister's daughter, Grandkid. Brother was adopted. Their ownership of Xavier Corporation is as shown in the following table:⁶⁹

⁶³ IRC Sections 408(k)(6)(G); 416(i)(1)(A) and (B).

⁶⁴ IRC Sections 416(i).

⁶⁵ IRC Section 318(a)(1)(B).

⁶⁶ IRC Section 318(a)(1)(A)(i).

⁶⁷ IRC Section 318(a)(1)(A)(ii).

⁶⁸ IRC Section 318(a)(1)(B).

⁶⁹ See, S. Derrin Watson, "Who's The Employer," Q 14:7 (3rd Ed, 2003) at <http://www.employerbook.com/WTE3/>. Examples used with permission.

Family Member	Shares
Dad	500
Mom	400
Sister	300
Brother	200
Grandkid	100

- Mom and Dad are each deemed to own all 1,500 shares.
- Sister is deemed to own 1,300 shares, all but Brother's.
- Brother is deemed to own 1,100 shares, excepting Sister's and Grandkid's.
- Grandkid is deemed to own 400 shares, just her own and her mother's.

Key Employee Family Attribution

Example. Each of the following owns 1 percent of Trout Corporation, namely, Sam, Sam's wife, Sam's mother, Sam's grandmother, Sam's son, and Sam's granddaughter (the daughter of Sam's son). Sam is deemed to own the stock of all those individuals other than Sam's grandmother. That gives Sam exactly 5 percent. Since a 5-percent owner is one who owns more than 5 percent of a company, Sam is not a 5-percent owner. Sam and each of his five family members is a 1-percent owner however, since each is deemed to own more than 1 percent.

No Double Family Attribution

Example. Son, Daughter, and Mother each own 2.5 percent of The Chrysanthemum Corporation. Son and Daughter are each deemed to own 5 percent, while Mother is deemed to own 7.5 percent. Son's stock cannot be attributed to Daughter through Mother. Son and Daughter are not 5-percent owners (again that requires more than 5 percent), while Mother is a 5-percent owner.

Option Precedence

Example. The facts are the same as in the preceding example, except Mother has an option to buy Son's stock. So, Mother is deemed to own Son's stock because of option attribution, not because of the family rules, which means it can be attributed from her to Daughter. Accordingly, both Mother and Daughter are deemed to own 7.5 percent of Chrysanthemum. Son is still deemed to own 5 percent.

Stepchildren

Example. Mabel owns 4 percent of Second Chance, Inc., and her stepson, Roy, owns 2 percent. On these facts, neither is a 5-percent owner. There is no

attribution between stepchild and stepparent. That would require double family attribution through Roy's father (Mabel's husband).

Stock Attribution, Not Compensation Attribution

Example. Dad owns 3 percent of Nepotism, Inc. His salary from the company is \$160,000 per year and hence he is an HCE and a key employee. Daughter does not own any stock in the company, but does receive a salary of \$40,000 per year. Daughter is not an HCE or a key employee. She is deemed to own Dad's stock, but 3-percent ownership will not make her an HCE. His compensation is not attributed to her, and her compensation is insufficient to make her an HCE or a key employee.

ERISA Considerations

SEP are pension plans generally subject to the requirements of ERISA, including its reporting and disclosure obligations. Simple annual reporting requirements apply if the employer has adopted the IRS model SEP without modification. In that case, the employer need only have complied as follows:

1. Provide employees with copies of the completed Form 5305-SEP.
2. Notify each employee in writing of the amount of employer contribution for the year.
3. If the employer selected or otherwise influenced an employee's selection of a particular IRA that restricts the withdrawal of funds, provide a written explanation of the restrictions and inform the employee of the availability of IRAs that do not restrict withdrawal.

An employer must also inform its employees of the SEP's adoption and its terms, including a description of participation requirements and the benefit allocation formula. Such information is to be provided within a reasonable time after an employee becomes employed (or after the SEP is adopted, if later). The instructions to IRS Form 5305-SEP indicate this requirement is satisfied if the employer adopts the IRS model SEP and gives the employee a photocopy of the completed Form 5305-SEP. Similar requirements apply to a prototype SEP. The sponsor of a prototype SEP will generally provide a "fill-in-the-blanks" disclosure statement designed to satisfy ERISA's annual reporting requirements. An employer must also provide each employee annually with a statement showing the amount contributed to the IRA on the employee's behalf. This requirement is satisfied if the information is recorded on an employee's Form W-2. If the employer cannot locate an employee, the IRS may require that the employer file reports with the IRS for the employee.

Form Filing

Employers maintaining SEP or SARSEP arrangements generally do not have to file any of the Form 5500 series annual return/reports for employee benefit plans when they conform to the alternate methods of compliance. Generally, under Title I of ERISA, relief from the annual reporting requirements is not available to an employer who selects, recommends, or in any other way influences employees to choose a particular IRA or type of IRA into which contributions under the SEP will be made *if* those IRAs are subject to restrictions that prohibit the withdrawal of funds for any period (other than restrictions imposed by the Code that apply to all IRAs). Under current law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Such reports could appropriately include information about compliance with the requirements that apply to SEP, including the contribution limits.⁷⁰ The IRS is concerned that many employers are not covering all of their eligible employees. It is likely that simplified reports will eventually be mandated for SEP plans.

Bonding

In most cases, an employer that handles funds or other property that belongs to an ERISA plan (including a SEP or SIMPLE) is required to be bonded. The basic standard is determined by the possibility of risk or loss in each situation; thus, it is based upon the facts and circumstances in each situation. The amount of such bond, which is determined at the beginning of each year, cannot be less than 10 percent of the amount of funds handled. The minimum bond is \$1,000. However, contributions made by withholding from an employee's salary are not considered funds or other property of a SIMPLE (or SEP) for purposes of the bonding provisions so long as they are retained in and not segregated in any way from the general assets of the withholding employer. Because employer contributions are made into IRAs established by each employee (which are outside the control of an employer once made), the bonding requirements would not generally apply to a SIMPLE IRA plan.⁷¹

Forwarding Contributions

Notwithstanding the deduction timing rules, ERISA regulations generally require that employee contributions be deposited as soon as they can reasonably be segregated from the employer's general assets, but in any event within 15 business days (30 days in the case of a SIMPLE IRA) after the end of the month in which the payroll deduction is made.⁷² The 15- and 30-day period are not safe harbors. Special considerations apply to partners. The forwarding

⁷⁰ IRC Sections 416(i).

⁷¹ ERISA Sections 404(c), 412; DOL Reg. Sections 2510.3-3, 2550.412-5. 66 DOL Reg. Section 2510.3-102.

⁷² IRC Section 318(a)(1)(A)(ii).

requirements for elective contributions are more fully discussed in Chapter 19.

Example. Finicky Partners maintains a SARSEP or 401(k) plan and the relevant ADP test is satisfied. On December 31, 2004, the last day of its taxable year, each of the seven partners individually elects to defer the maximum amount into the plan (not to exceed \$13,000 per partner). During 2004, each partner had a monthly draw of \$3,300 cash against eventual earnings. Finicky Partners' accountant, Katrina, is ill and is unable to compute the partnership's net earnings by the due date of the partnership's tax return. He files for an automatic three-month extension on behalf of the partnership return (July 15, 2005). Each of the partners' returns are extended to at least that date. On June 27, 2005, the accountant notifies the partnership that it indeed had a profit and that each of the partners is due an additional \$20,000 distribution of profits. Finicky Partners must deposit \$91,000 (\$13,000 multiplied by 7) as contributions to the 401(k) trustee or custodian of the seven partners, as soon as they can be deposited, but no later than 15 business days after the end of June. For deduction purposes, the elective amounts and any nonelective employer contributions must be deposited by July 15, 2005, the extended due date of Finicky's 2003 tax return.⁷³

Example. Same facts as in the preceding example, except Katrina determines that each partner is only due an addition profit distribution of \$5,000. The monthly draw (\$3,300) has already been paid, so it cannot be considered for deferral purposes. Thus, only \$35,000 (\$5,000 x 7) may be deferred.

Minimum Required Distributions

The RMD rules, which generally require that distributions begin by the April 1 following the calendar year in which a plan participant attains age 70½, apply to IRAs, IRAs established under SEP, and qualified plans (such as a profit-sharing plan, or a profit-sharing plan with a 401(k) feature).

There is little difference in the application of the RMD distribution rules to these various types of plans. One key difference, however, is that employees who continue to work after the normal retirement date are not required to commence distributions in a qualified plan. Employees covered by a SEP are required to commence distributions regardless of whether they actually retire (the same rule as for IRAs). The RMD rules are more fully discussed in Chapter 13, "Required Minimum Distributions."

⁷³ See, Treas. Reg. Section 1.401(k), Preamble; DOL Reg. Section 2510.3-102; Ltr. Rul. 200247052 (Aug. 28, 2002).

Early Distributions

The 10-percent excise tax for early distributions may apply to distributions before age 59½ from IRAs as well as from IRAs established under a SEP. This topic and the exceptions from the penalty tax are discussed in Chapter 15, “Rollovers and Portability.”

Regular and Premature Distribution Taxation

Distributions of SEP contributions (including gain) are taxed in the same manner as traditional IRA distributions. Distributions are subject to federal income tax except to the extent of any basis attributable to nondeductible contributions. Distributions made prior to age 59½ may be subject to a 10-percent premature distribution excise tax unless any of the exceptions apply. Other rules may apply to SARSEP distributions and the removal of excess contributions.

Lump-Sum Distributions

Lump-sum distributions from qualified plans are eligible for favorable tax treatment. This special lump-sum distribution tax treatment is not available for distributions from IRAs, including distributions from IRAs established under a SEP. In addition, distributions from an IRA, including an IRA established under a SEP, were not allowed to be rolled over into a qualified plan for years before 2002, but can be rolled over beginning in 2002. Qualified plan distributions may, of course, be rolled over into an IRA under appropriate circumstances, and in the case of a conduit IRA (see Chapter 15), the original qualified plan distributions may effectively later be rolled over again into a qualified plan. In that case, the monies may be eligible for lump-sum distribution tax treatment (10-year forward income averaging and/or capital gains treatment for net unrealized appreciation in distributed employer securities) when distributed from the qualified plan after five years of participation in the plan.⁷⁴

If amounts are transferred directly from one qualified plan to another qualified plan, if the employee participated in either plan or both plans for a total of at least five taxable years before the taxable year in which the distribution is made from the transferee plan, the minimum five-year participation requirement may be satisfied.⁷⁵

⁷⁴ Prop. Treas. Reg. Section 1.402(e)-2(e)(3).

⁷⁵ Ltr. Rul. 8004092 (Oct. 31, 1979) permitted tacking of participation years under separate plans when entity incorporated and transferred assets from terminated Keogh plan into new corporate plan.

Loans

An individual may not borrow from an IRA, including an IRA established under a SEP, whether or not the individual is an owner/employee.

Termination of SEP Plan

Termination of a SEP is simpler than termination of a qualified plan. IRS approval is not required to terminate a SEP (or a SARSEP). If an employer wishes to permanently discontinue contributions including elective deferrals, it may amend the SEP (or SARSEP). A copy of the amendment, as well as an explanation of the amendment (and its effect on participants), must be given to participants. A nonelective SEP could just remain dormant.

Protection From Creditors

In the case of an IRA, including an IRA established under a SEP, there is generally no protection of those assets from creditors (bankruptcy or otherwise) under federal law, because IRS anti-alienation rules for qualified plans do not apply, and normally ERISA's anti-alienation rule will not apply. As with qualified plan assets, IRA assets are subject to IRS tax levies (although an exception to the 10-percent early distribution excise tax was recently added to the Code for such purpose).⁷⁶ Many states offer protection for IRAs, under which creditors of an IRA owner cannot gain access to the debtor's IRA amounts or have only restricted access to those amounts. For SEP, however, state statutes protecting an individual's SEP IRA from his or her creditors, or exempting those assets from inclusion in the individual's bankruptcy estate, may be preempted by ERISA because SEP, unlike IRAs, are generally subject to ERISA. This rationale leaves open the possibility that state laws protecting SEP assets from the reach of creditors will be preempted when the participant is not in bankruptcy. Creditor protection is more fully discussed in Chapter 17, "Creditor Protection."

Tax Credits

Tax Credit for Employers

A small business that adopts a new SEP (or SIMPLE) can generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The credit is available only to employers that did not have more than 100 employ-

⁷⁶ IRC Section 72(t).

ees with compensation in excess of \$5,000 during the previous tax year. The employer must have had at least one NHCE. The credit is taken as a general business credit on the employer's tax return. The other 50 percent of the expenses may be taken as a business deduction. The expenses must be paid or incurred in taxable years beginning after 2001 and with respect to plans established after 2001.⁷⁷ The credit is more fully discussed in Chapter 1, "Introduction."

Tax Credit for Employees

For the five taxable years beginning after 2001 (i.e., 2002 to 2006), certain low-income taxpayers may receive a nonrefundable contribution credit for a percentage of their contributions. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a SEP (or SIMPLE) IRA. The credit is in addition to any other tax benefit (i.e., a possible tax reduction) that the contribution gives the taxpayer.⁷⁸ The tax credit for employees is more fully discussed in Chapter 1.

Retirement Planning Advice Provided by Employers

EGTRRA clarifies that retirement planning advice provided by employers to employees (and their spouses) after 2001 on an individual basis is a nontaxable fringe benefit to the extent such services are made available on substantially equivalent terms to all employees.⁷⁹ See Chapter 1 for more information.

Plan Correction Programs—EPCRS, VFPC, and DFVC

The IRS's Employee Plans Compliance Resolution System (EPCRS) and the DOL's Voluntary Fiduciary Correction Program (VFPC) are more fully discussed in Chapter 12, "Plan Correction Programs—EPCRS, VFPC, and DFVC." The EPCRS is a comprehensive system of integrated correction programs that plan sponsors may use to correct eligible failures and to continue providing their employees with retirement benefits on a tax-favored basis. VFPC allows certain persons to avoid potential civil actions, penalties, and the assessment of civil penalties under ERISA. In general, the exemption affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.

The Delinquent Filer Voluntary Compliance Program (DFVC) is designed to encourage voluntary compliance with the annual reporting requirements under ERISA and is also discussed in Chapter 12.

⁷⁷ IRC Section 45E.

⁷⁸ IRC Section 25B(a), 25B(b).

⁷⁹ IRC Section 132(a)(7), 132(m)(1).

SEP Compared to a Qualified Plan

A SEP program can compare favorably with a qualified plan even though fully vested SEP contributions would generally be made for transient employees with *three* or more years of service. A qualified plan's shorter eligibility requirement (generally a requirement of one year and 1,000 hours-of service) *may* result in contributions having to be made or allocated to more employees. Although the qualified plan would most likely have a vesting schedule applied to employer-derived accrued benefits or account balances, the schedule is applied to an additional two years of contributions made by the employer. The plan that offers the least employee cost at all points along an employee's employment time line can be identified only after considering many factors, including the potential growth of the business, the age of the employee, employee turnover, whether the employee was employed on the last day of the plan year, whether the employee worked at least 500 or 1,000 hours, work patterns, and so on. In addition, there must be an analysis of a group's eligibility to participate initially and then to receive contributions (and the extent to which those contributions will be vested upon an employee's termination of service).

SEP Advantages and Disadvantages

SEPs provide a number of advantages, as well as disadvantages. Each are discussed in the following sections.

SEP Advantages

The advantages of SEP are as follows:

- SEP are easy to establish, and their enumerated administrative burdens are minimal, especially if the IRS model is used.
- SEP are easy to understand and communicate to employees.
- SEP disclosure notice is only required initially and whenever the SEP is amended.
- SEP have limited fiduciary liability.
- SEP are cost-effective.
- SEP are less burdensome to administer than qualified plans.
- Contributions may be as high as \$41,000 (\$44,000 with catch-up contributions) for 2004.
- Contributions may be changed from year to year and, unlike under a qualified plan, need not be recurring; that is, an employer can make a contribution simply for one or two years, without the need to make contributions in any succeeding years.

- Minimal reporting requirements apply (the assets are held and accounted for by the IRA custodian or trustee); in particular, Form 5500 and summary plan descriptions normally are not required.
- SEP may be adopted by the deadline for filing the employer's federal income tax return for the year for which the employer wishes to take a deduction; this is in contrast to the requirement that a qualified plan be adopted by the last day of the employer's taxable year for which the plan is to be effective.
- In determining whether a SEP is top heavy, an employer may elect that the SEP count only aggregate employer contributions (presumably for all years), rather than the total amount in employees' accounts. This election (or default) may be contained in the SEP document established by the employer.
- There are no vesting schedules for SEPs. Vesting is 100 percent and immediate.
- SEP contributions may be integrated with Social Security benefits, thereby increasing the percentage of total contributions allocated to HCEs.
- Elective (including catch-up) contributions are deductible in addition to the 25 percent of preplan aggregate compensation deduction limit.
- For HCEs only, the \$41,000 (for 2004) limit is reduced if the plan is integrated with Social Security.

SEP Disadvantages

An employer wishing to ensure that employees will not spend their retirement monies prior to retirement should establish a qualified plan under which distributions are not permitted prior to some retirement age, such as age 65. Under an IRA, including an IRA established under a SEP, employees have an unfettered right to withdraw monies from their IRAs at any time, although they may face a 10-percent penalty for premature distribution. The following are also disadvantages:

- Most employees, including part-time employees, who have worked during three of the last five years, must receive a contribution.
- Contributions are nonforfeitable (vested) when made.
- Leased employees generally must be covered.
- Deductible contributions in excess of a participant's 25 percent of includable compensation may have to be included in the participant's gross income.
- Employees can remove monies from their accounts immediately, leaving them with no funds at actual retirement.
- Loans are not permitted.
- Creditors of employees may be able to gain access to SEP assets (although perhaps not in cases in which the employee becomes bankrupt).

or applicable state law shields SEP amounts from the employee's creditors in bankruptcy).

- Employees cannot be required to be employed on the last day of the year, or to work a minimum number of hours during the year, in order to receive a contribution.
- Investments are limited by IRA rules and must be held by an IRS-approved trustee or a custodian.
- Life insurance may not be held in a SEP.
- No lump-sum distribution or 10-year averaging of capital gains treatment is available for distributions.
- Employee pretax elective contributions are permitted only if there are no more than 25 eligible employees in the preceding plan year and at least 50 percent of eligible employees choose to make pretax contributions; in addition, discrimination tests apply to each HCE on an individual basis, rather than on the basis of average contributions made by HCEs (as under a qualified 401(k) plan); no matching contributions are permitted on pretax deferrals to a SEP.
- Unlike for qualified plans, there is no exception from the early distribution tax for distributions (1) after separation from service after attaining age 55, (2) for deductible medical expenses, or (3) to alternate payees under a qualified domestic relations order. On the other hand, the early distribution tax exception for periodic payments applies whether or not the individual has separated from service, whereas for qualified plans that exception applies only for payments beginning after the employee's separation from service.
- The SEP is required to include employees who earn less than \$450 in 2004.
- Employer may not make matching contributions.

Exhibit 2-1. SEP Checklist for 2004

Every year it is important to review the requirements for operating a Simplified Employee Pension plan (SEP). This SEP Checklist has been designed as a quick tool to help keep your SEP in compliance with important tax rules. This SEP Checklist is not a complete description of all the requirements and it is not a substitute for a comprehensive plan review.

	YES	NO
1. Are all <u>eligible employees</u> participating in the SEP? <i>(Any employee who is at least 21 years of age, was employed by you for 3 of the immediately preceding 5 years, and received <u>compensation</u> from you of at least \$450 is eligible to participate in a SEP.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
2. Is the <u>business</u> that this SEP covers the only business that you and/or your family members own? <i>(Employees of other businesses you and/or your family members own may have to be treated as employees in determining who is an eligible employee under this SEP.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have you given all of your eligible employees <u>information about the SEP</u> , including a copy of the SEP agreement? <i>(You must give your employees certain information about the SEP including a copy of the SEP agreement. Form 5305-SEP is your SEP agreement if you use the model form.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
4. Are you determining each eligible employee's <u>compensation</u> using an appropriate definition in accordance with your SEP agreement? <i>(Compensation cannot exceed \$205,000 in 2004.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
5. Are the contributions made to a <u>traditional IRA</u> ? <i>(All SEP contributions must go to traditional IRAs set up for the eligible employees.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
6. Are SEP contributions to each employee's IRA <u>limited</u> as required by law? <i>(Contributions to a SEP-IRA are limited to the lesser of 25% of the employee's compensation for the year or \$41,000 for 2004.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
7. Are employer contributions immediately 100% <u>vested</u> ? <i>(Employer contributions cannot be conditioned on anything. Once made, the employee owns all contributions.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
8. Have you made required <u>top-heavy minimum</u> contributions to the SEP? <i>(If a SEP is top-heavy or deemed top-heavy, contributions must be made for the non-key employees equal to the lesser of 3% of compensation or a percentage equal to the highest contribution rate of any key employee.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
9. Did you <u>timely deposit</u> the employer contributions into the SEP-IRAs? <i>(Employers have until the due date, including extensions, of their tax return for the tax year that includes the last day of the calendar year (if the SEP is maintained on a calendar year basis) to deposit employer contributions.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
10. If the model Form 5305-SEP was used to set up the plan, is this SEP your business's <u>only employee retirement plan</u> ? <i>(A sponsor of a SEP established using model Form 5305-SEP cannot sponsor another retirement plan, such as a 401(k) plan.)</i>	<input type="checkbox"/>	<input type="checkbox"/>

If you answered "No" to any of the above questions, you may have made a mistake in operating your SEP. For employer use only; do not file this form with IRS.

Exhibit 2-2. SARSEP Checklist for 2004

Every year it is important to review the requirements for operating a Salary Reduction Simplified Employee Pension (SARSEP). This checklist is designed as a quick tool to help keep a SARSEP in compliance with important tax rules. The checklist is not a complete description of all the requirements and it is not a substitute for a comprehensive plan review.

	YES	NO
1. Was your SARSEP established prior to <u>January 1, 1997</u> and subsequently amended for <u>current law</u> ? (No new SARSEPs can be established after 1996. SARSEPs should be updated to benefit from the new law.)	<input type="checkbox"/>	<input type="checkbox"/>
2. Did you have <u>25 or fewer</u> eligible employees at all times during the prior year? (Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.)	<input type="checkbox"/>	<input type="checkbox"/>
3. Are <u>all employees</u> who have attained age 21, worked for you in at least 3 of the last 5 years and have received at least \$450 in compensation included in the plan? (Employees of other businesses you and/or your family members own may have to be treated as employees in determining who is an eligible employee under this SEP.)	<input type="checkbox"/>	<input type="checkbox"/>
4. Have you <u>notified participants of any changes</u> in the SARSEP? (Participants must be given <u>notice</u> before changes go into effect.)	<input type="checkbox"/>	<input type="checkbox"/>
5. Are all <u>employee elective deferrals</u> within the appropriate limit: \$13,000 for 2004. (If the employee is age 50 or over, an additional catch-up contribution up to \$3,000 can be made in 2004.)	<input type="checkbox"/>	<input type="checkbox"/>
6. Do <u>50% or more</u> of all <u>eligible employees</u> make employee deferrals? (At least half of your employees must make employee elective deferrals to the SARSEP.)	<input type="checkbox"/>	<input type="checkbox"/>
7. Are <u>total contributions</u> (employee elective deferrals and nonelective employer contributions) no more than 25% of <u>compensation</u> as defined in the SARSEP? (For 2004, contributions are limited to the lesser of 25% of compensation or \$41,000.) SARSEPs do not permit employers to make matching contributions to participants' accounts.)	<input type="checkbox"/>	<input type="checkbox"/>
8. Did you <u>timely deposit</u> employee elective deferrals? (Employee deferrals must be remitted to the appropriate financial institution as soon as possible but in any event, no later than 15 days following the month in which the employee would have otherwise received the money.)	<input type="checkbox"/>	<input type="checkbox"/>
9. Did you perform the annual <u>average deferral percentage test</u> and timely notify employees? (The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125% of the average deferral percentage of all eligible nonhighly compensated employees. Notice provided within 2-1/2 months.)	<input type="checkbox"/>	<input type="checkbox"/>
10. Have you made required top-heavy minimum contributions to the SARSEP? (Refer to your plan document for information. Most plans are deemed top-heavy, but some plans require annual testing.)	<input type="checkbox"/>	<input type="checkbox"/>

If you answered "No" to any of the above questions, you may have made a mistake in operating your SARSEP. For employer use only; do not file this form with IRS.

Source www.irs.gov (modified by author).

Chapter 3

SIMPLE Plans

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SIMPLE Plans

A savings incentive match plan for employees (SIMPLE) is a simplified retirement plan for small businesses that allows employees to make elective pretax contributions and requires employers to make matching or, alternatively, nonelective contributions. A SIMPLE may be part of a 401(k) plan or it may be used as an individual retirement account or annuity (IRA). When it is used as an IRA, it is known as a SIMPLE IRA. See comprehensive illustrations in Appendix A, “Plan Feature Comparison Charts.”

Contributions are limited to employee elective contributions and required employer matching contributions or nonelective contributions. No other contributions are permitted, except rollovers from another SIMPLE IRA.

EGTRRA Sunset

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made changes to the rules regarding SIMPLE plans. Although most of the provisions became effective in 2002, some of the provisions were effective in 2001. Most are phased in over several years, and some are set to expire sooner than others. The entire law will sunset after December 31, 2010. This means that if Congress does not act to extend these provisions, the law would revert back to the rules as they existed prior to EGTRRA. Catch-up elective contributions would be eliminated if the EGTRRA were to sunset.

SIMPLE IRA Plans

A SIMPLE IRA plan is an IRA that satisfies several additional rules and also includes a qualified salary-reduction arrangement.¹ The plan under which contributions are made is called a SIMPLE to distinguish it from a SIMPLE arrangement established in the form of a qualified 401(k) plan (called a 401(k) SIMPLE), which are separately discussed below. When established in IRA form, many of the qualified plan rules do not apply.

Each employee decides whether to contribute and in that way reduce the amount of his or her compensation for tax purposes, as well. Contributions are made by the employer to an IRA called a SIMPLE IRA to which the only contributions that may be made are contributions under a SIMPLE IRA plan and rollovers or transfers from another SIMPLE IRA. No other types of contributions are permitted to be made under a SIMPLE.

Each contributing employee may choose whether to have the employer make payments as contributions under the SIMPLE IRA plan or to receive these payments directly in cash.

Employer Eligibility

A SIMPLE-IRA plan may be established by an eligible employer but generally must be the only plan maintained by that employer. The following types of business entities are eligible to establish a SIMPLE:

- Corporations
- Partnerships
- S corporations
- Sole proprietors (individuals who own the entire interest in an unincorporated trade or business operated for profit)
- Limited liability companies (LLCs)
- Limited liability partnerships (LLPs)
- Nonprofit and government entities

The term *plan* includes a qualified plan or annuity, a governmental plan, a tax-sheltered annuity or custodial account, a simplified employee pension (SEP), or a simple retirement account.²

Example. Mega Incorporated and Merger Incorporated are both owned by Buddy. The entities are located in different states. They each adopt a separate SIMPLE. Notwithstanding that both Mega and Merger are treated as a

¹ The provisions relating to SIMPLEs are effective for years beginning after December 31, 1996. The Small Business Job Protection Act of 1996 (SBJPA, Public Law 104-188) was signed by President Bill Clinton on August 20, 1996. See SBJPA Section 1421.

² IRC Sections 219(g)(5), 408(p)(2)(D).

single employer, the adoption of a second *plan* invalidates the adoption of both SIMPLE plans.

SIMPLE IRA Requirements

The general requirements for a SIMPLE established in the form of an IRA are the following:

1. The employer must be an eligible employer for the calendar year. Although a tax-exempt employer may *not* maintain a salary-reduction or elective SEP (SARSEP), it may establish a SIMPLE. A governmental employer may also establish a SIMPLE (if allowed by state enabling statutes).³
2. The only contributions permitted are contributions under a qualified salary-reduction arrangement.⁴
3. All contributions must be fully vested.⁵
4. Eligible employees must have the option to participate.⁶
5. Special administrative requirements must be satisfied (e.g., each eligible employee must be notified at least 60 days before the election period that he or she may make or change a salary-reduction election and whether he or she may elect the financial institution that will serve as trustee or custodian of the plan).⁷

The Employer

The term *employer* includes all related employers. All related employers should adopt the SIMPLE by affixing their signatures to the SIMPLE agreement (and by adopting a written resolution if necessary). A *related employer* is either a member of an affiliated service group, a controlled group of corporations, or a trade or business under common control.⁸ In other words, all employees of all employers that are related are *treated* as if employed by a single employer for SIMPLE purposes. An exception is provided, however, if an employer becomes or ceases to be related. The exception only applies during the transition period which begins on the date of the change in members of the group and ends on the last day of the first plan year beginning after the date of such change. In general, if the coverage requirements were satisfied before each change and coverage under the plan is not significantly changed during the transition period (other than change by reason of the change in members

³ Notice 98-4, Q&A B-4 (1998-2 IRB 26).

⁴ IRC Section 408(p)(1).

⁵ IRC Section 408(p)(3).

⁶ IRC Section 408(p)(4)(A) and (B).

⁷ IRC Section 408(p)(3).

⁸ IRC Section 414(b), (c), (m) or (o).

of the group), the participation rules will continue to be satisfied during the transition period.⁹

Example. Primary Insurance has 60 employees, who all participate in a SIMPLE IRA. Berry Insurers, an unrelated employer, maintains a qualified plan for its 80 eligible employees. On May 1, 2004, Primary purchases Berry and becomes the parent in a parent-subsidiary controlled group. Primary may continue to maintain its SIMPLE IRA for its 60 employees, as well as future eligible employees from May 1, 2004, to December 31, 2005. Coverage under the SIMPLE IRA may not be significantly changed, and only individuals who would have been employees of Primary had the transaction not occurred may participate.

Special complications arise if an employer maintains more than one SIMPLE or makes contributions to a qualified plan. As previously stated, a SIMPLE generally must be the employer's only plan. If elective contributions are made to more than one plan of an employer or multiple employers (other than an eligible 457 plan), the limit under Internal Revenue Code (IRC or the Code) Section 402(g), \$13,000 for 2004, generally applies, even though elective SIMPLE contributions cannot exceed \$9,000 plus catch-up contributions (up to \$1,500) for 2004.

SIMPLE Plan Adoption

An employer can establish a SIMPLE IRA plan by adopting either (1) an IRS model agreement, using Form 5304-SIMPLE or Form 5305-SIMPLE; (2) a prototype SIMPLE IRA sponsored by a qualified financial institution (e.g., a bank or insurance company); or (3) an individually designed plan.

A prototype or model SIMPLE plan must be used with an IRS model SIMPLE IRA (Form 5305-S or 5305-SA) or an IRS-approved prototype SIMPLE IRA.¹⁰

In May 2002, the IRS issued new model SIMPLE forms that have been amended for EGTRRA and the required minimum distribution (RMD) regulations. Beginning October 1, 2002, these amended model forms must be used to establish new SIMPLE IRA plans and new model SIMPLE IRAs. Model SIMPLE IRA plans existing at that date were required to be amended for EGTRRA and adopted by employers by December 31, 2002. This step required an employer signature. Employees were not required to sign the document to adopt the SIMPLE IRA. A mass mailing of the new document to employees was sufficient.¹¹

⁹ IRC Section 410(b)(6)(C); see Rev. Rul. 2004-11 (2004-7___) IRB 480___) regarding the transition rule on a pension and profit-sharing plan following a sale of subsidiary stock to an unrelated employer.

¹⁰ Rev. Proc. 87-50 (1987-2 CB 647); Rev. Proc. 97-29 (1997-1 CB 698).

¹¹ Rev. Proc. 2002-10 (2002-4 IRB 401); IRS Ann. 2002-49 (2002-19 IRB 919).

Effective Date

The *effective date* is the date that the provisions of a plan become effective. Except for the first plan year that the employer is adopting a SIMPLE IRA, the effective date must be January 1.¹²

In all other cases, the effective date cannot be any later than October 1. Special rules, however, apply to new employers that are formed after October 1. The effective date is used primarily for determining the required 60-day enrollment period.¹³

100-Employee Rule

Employers who employed 100 or fewer employees who earned \$5,000 or more in compensation for the preceding calendar year are generally eligible to adopt a SIMPLE IRA. Although an employer may elect to exclude employees covered under a collective bargaining agreement for which retirement benefits were the subject of good-faith bargaining, those employees are nonetheless included for the purpose of the *100-employee limitation*. Any type of business entity can establish a SIMPLE IRA, including tax-exempt employers and governmental entities.¹⁴ Employees include self-employed individuals (owners of unincorporated businesses) who received earned income from the employer during the year.¹⁵

Caution: For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE. Thus, certain unionized employees who are excludable under the rules of IRS Section 410(b)(3), nonresident alien employees, and employees who have not met the plan's minimum eligibility requirements must be taken into account. Any such employee, however, can be excluded for the purpose of determining the employee's eligibility to participate.¹⁶

Exclusive Plan Requirement

Except for a plan whose only participants are employees covered under a collective bargaining agreement (and who are excluded from participating in the SIMPLE IRA plan), an employer may not maintain a SIMPLE if it maintains another qualified plan, a SEP, a SARSEP, or a 403(b) tax-sheltered annuity plan.¹⁷ Furthermore, an employer may not maintain more than one SIMPLE.¹⁸

¹² IRC Section 408(p)(6)(C).

¹³ IRC Section 408(p)(5).

¹⁴ IRC Section 408(p)(2)(C)(i).

¹⁵ IRC Section 408(p)(6)(B).

¹⁶ IRC Sections 401(c)(1), 408(p)(2)(C)(i)(I), 408(p)(4)(B).

¹⁷ IRC Section 408(p)(2)(D)(i).

¹⁸ IRC Section 219(g)(5).

Example. In 1992, Christine Manufacturing, Inc., the plan sponsor, established a money purchase pension plan for employees who perform work subject to prevailing-wage rates under the Davis-Bacon Act. In 2004, the IRS selected for a limited scope audit the money-purchase pension plan's Form 5500, Annual Return/Report for Employee Benefit Plan. In handling the audit, the sponsor's third-party administrator (TPA), who has expertise in the qualified plan area, learned that the plan sponsor had adopted a SIMPLE IRA plan on a company-wide basis in 2000 intended to satisfy the requirements of IRC Section 408(p). The plan sponsor had established the plan on the basis of a good-faith belief that its qualified plan for prevailing wage employees under the Davis-Bacon Act satisfied the exception to the exclusive-plan rule in IRC Section 408(p)(2)(D), relating to plans maintained for collectively bargained employees. Unbeknown to its TPA and other advisers, the plan sponsor maintained and made contributions to the money-purchase pension plan for every calendar year that the SIMPLE IRA was in existence (2000 through 2004). Christine Manufacturing is not eligible to maintain a SIMPLE IRA plan; thus, the SIMPLE IRA contributions (employee salary deferrals and employer matching contributions made on behalf of employees) are rendered nondeductible or prohibited excess contributions in each of those years. The Employee Plans Compliance Resolution System (EPCRS)¹⁹ can be used to correct this failure. See Chapter 12, "Plan Correction Programs—EPCRS, VFCP, and DFVC."

Acquisitions, Dispositions, and Similar Transactions

Special rules called the *grace-period rules* apply upon an employer's acquisition, disposition, or similar transaction for purposes of (1) the 100-employee limit, (2) the exclusive plan requirement, and (3) the service and compensation coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary-reduction arrangement for the year of the transaction and the two following years, provided (1) such requirements were met immediately before each such change and (2) such arrangement would satisfy the requirements to be a qualified salary-reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.¹⁹

Example. Jordan owns Amber, a computer rental agency that has 80 employees, each of whom received more than \$5,000 in compensation in 2003. Jordan also owns Bright, a company that repairs computers and has 60 employees who received more than \$5,000 in compensation in 2003. Jordan is the sole proprietor of both businesses. IRC Section 414(c) provides that the employees of partnerships and sole proprietorships that are under common control are treated as employees of a single employer. Thus, for purposes of SIMPLE rules, all 140 employees are treated as being employed by Amber. As a result, neither Amber nor Bright is eligible to establish a SIMPLE for 2004.

¹⁹ IRC Sections 408(p)(10), 410(b)(6)(C)(i)(II).

Example. Cobra Company employed 90 individuals during 2003 and 2004. It establishes a SIMPLE IRA for 2004 for employees who earned at least \$5,000 from Cobra during any two previous years. During 2005, Cobra hires 50 additional employees. All employees earn at least \$5,000. If it were not for the grace period, Cobra would not be eligible to maintain a SIMPLE for 2006 because it employed more than 100 employees earning at least \$5,000 in 2005 (the preceding year).

Example. Blueberry Corporation employed 90 individuals during 2002 and 2003. All employees earn at least \$5,000. Blueberry establishes a SIMPLE IRA for 2004 for those employees who earned at least \$5,000 from the company during any two previous years. During 2004, Blueberry hires 50 new employees. Although Blueberry would be ineligible to initially establish a SIMPLE for 2005 because it had more than 100 employees earning at least \$5,000 during 2004, it may continue to maintain its existing SIMPLE during the two-year grace period that is, for 2005 and 2006.

Example. Roller Skate Company employed 85 individuals during 2002 and 2003. All employees earn at least \$5,000. Roller Skate establishes a SIMPLE IRA for 2004 for employees who earned at least \$5,000 from the company during any two previous years. Sixty of the original 85 employees quit during the first half of 2004. During the second half of 2004, Roller Skate hired 50 additional employees. Roller Skate would not be an eligible employer for 2005 if it were not for the grace period (because it had more than 100 employees during 2004 with compensation of \$5,000 or more).

Exclusive Plan Requirement

An employer that maintains a SIMPLE during any part of the calendar year may generally not maintain a qualified plan with respect to which contributions are made or benefits are accrued for service in that calendar year. For this purpose, a qualified plan includes, for example, a SEP, SARSEP, profit-sharing plan, money-purchase pension plan, or defined-benefit pension plan.²⁰ An employer that maintains more than one SIMPLE plan is also in violation of the exclusive plan requirement.²¹ A qualified plan, however, whose only participants are employees covered under a collective bargaining agreement is disregarded if these employees are excluded from participating in the SIMPLE IRA plan.

Example. Sid owns 95 percent of Marvin Gardens Company and 87 percent of Charles Place Corporation. Marvin Gardens established a SIMPLE IRA for its employees specifying a prior year's compensation requirement of \$2,000. To avoid covering some of the employees in Charles Place, Marvin Gardens establishes a second SIMPLE IRA that specifies a \$5,000 prior year's compensation requirement. Because both Marvin Gardens and Charles Place

²⁰ IRC Section 408(p)(2)(D)(ii).

²¹ IRC Section 219(g)(5).

are part of a controlled group, and thus are treated as a single employer, neither of the plans passes muster because the exclusive plan requirement has been violated.

Employee Eligibility Requirements

Each employee, regardless of age, who received at least \$5,000 in compensation from the employer during any two preceding calendar years (whether or not consecutive) and who is *reasonably expected* to receive at least \$5,000 in compensation during the calendar year must be eligible to participate in the SIMPLE IRA plan for the calendar year.²² For purposes of the SIMPLE IRA, compensation includes wages, tips, and any other pay from the employer subject to income tax withholding, and deferred amounts that were elected in that year under any 401(k), 403(b), governmental 457(b) plan, SEP, or SIMPLE.

A self-employed individual's compensation for the year is his or her net earnings from self-employment (NESE) before subtracting any contributions made to a SIMPLE IRA on his or her behalf.²³ However, a self-employed individual may use only 92.35 percent of his or her NESE because of the 7.65 percent *in lieu of* deduction used in computing NESE.²⁴

Excluded Employees

An employer may elect to exclude the following employees from participation:²⁵

1. An employee covered under a collective bargaining agreement for which retirement benefits were the subject of good-faith bargaining.
2. An employee who is a nonresident alien and received no earned income from sources within the United States.
3. An employee who would not have been an eligible employee if an acquisition, disposition, or similar transaction had not occurred during the year.

An employer may impose less restrictive eligibility requirements by eliminating or reducing the service requirement, the prior-year compensation requirement, the current-year compensation requirement, or all three.

Example. Sherri, the owner and only employee of a newly established small business, creates a SIMPLE IRA plan using a model SIMPLE for 2002. The plan does not have a service requirement. A new employee, Muffin, is hired in June 2002, and Sherri amends the plan to provide for one year of service so that Muffin will not be eligible to participate until the following year. In 2003, Sherri duly amends the plan, this time providing for a two-year

²² IRC Section 408(p)(4).

²³ IRC Section 408(p)(6)(A)(i).

²⁴ IRC Section 408(p)(6)(A)(ii).

²⁵ IRC Sections 408(p)(4)(B), 410(b)(3).

service requirement. Again, Muffin is ineligible. It is not known whether such a rolling eligibility period will pass IRS scrutiny.

Example. Sagado's employer maintains a SIMPLE IRA plan in 2004. The plan uses the maximum service provision (two years) and the maximum compensation amount (\$5,000) for determining eligibility. Sagado earned \$10,000 in 1996 and 1997 but did not perform any service during 1998, 1999, and 2000. During 2001 and 2002, Sagado earned \$2,600 each year. Sagado is reasonably expected to earn \$7,000 in 2004. He is therefore eligible to participate in the plan in 2004 because he can reasonably be expected to earn at least \$5,000 in compensation during the current year, and he has already earned \$5,000 in two previous years.²⁶

Example. Veronica has been a full-time employee of the Indomitable Ice Company for 18 years. Her annual salary is \$36,000. Shortly before the plan's election period (November 2 to December 31), Veronica requests and is granted an 11-month personal leave of absence to start on January 1, 2004. For 2004, Veronica is reasonably expected to earn only \$3,000 and will not be eligible to participate in the SIMPLE for 2004 if the company imposes a current compensation requirement in excess of \$3,000.

Example. The facts are the same as those in the preceding, except that (1) on January 2, 2004, Veronica decides not to take the leave of absence; (2) Indomitable Ice had duly elected to make the 2-percent nonelective contribution; and (3) the plan requires that an employee must be "reasonably expected" to have \$5,000 of current compensation to participate but requires only that an employee have \$2,000 of current compensation to receive a nonelective contribution. Veronica is not entitled to receive a nonelective contribution because she was not an eligible employee; that is, she was not reasonably expected to earn \$5,000 (even though she did earn more than \$2,000).

Participation in More Than One Plan

An employee may participate in a SIMPLE IRA plan even if the employee also participates in a plan of an unrelated employer for the same year. However, the employee's salary-reduction contributions generally are subject to an aggregate calendar-year limit of \$13,000 plus catch-up contributions on elective deferrals for 2004. It should be noted that the elective deferral limit applies separately to an eligible 457(b) plan.²⁷ Thus, catch-up contributions made to a governmental 457(b) plan do not reduce catch-up contributions in other types of plans (i.e., 403(b), 401(k), SIMPLE, or SARSEP plans).

Maximum Age Restrictions

There are no maximum age restrictions. Eligible employees may participate in a SIMPLE IRA plan regardless of their age. Unlike contributions to a tradi-

²⁶ 24 IRC Section 408(p)(4)(A), 408(p)(6)(B).

²⁷ IRC Section 402(g)(3).

tional IRA, SIMPLE contributions may be made by an employer to a SIMPLE IRA of an eligible employee after the employee reaches age 70½.

Note. The maximum \$15,000 annual limit that applies to exclusions of salary reductions and other elective deferrals in qualified and other types of plans under IRC Section 402(g) also applies on an individual level.²⁸ Therefore, if an employee is a participant in any other employer plans during the year and has elective salary reductions or deferred compensation under those plans, the salary-reduction contributions under the SIMPLE plan are also included in the \$15,000 annual limit.²⁹

Caution: *The IRS has determined that the employee, not the employer, is responsible for ensuring these requirements are not violated when the employee makes elective (pretax) contributions to qualified plans of unrelated employers. Therefore, the employee cannot rely on the employer's determining whether the elective limit has been exceeded due to salary exclusions under the plans of one or more other employers.*

An Employee

Only a common-law employee of the employer may participate in a SIMPLE IRA plan. The term *employee* also includes self-employed individuals (including partners in a partnership) and leased employees (as described in IRC Section 414(n)) but does not include nonresident aliens who receive no income from sources within the United States. An *eligible employee* means an employee who satisfies the age and compensation requirements (if any are set by the employer).³⁰

Domestic and Similar Workers

Currently, an employer may make a contribution on behalf of domestic and similar workers other than the employer or a member of the employer's family. The employer, however, is not afforded a deduction, because such contributions are not made in connection with a trade or business. For taxable years beginning after 2001, EGTRRA allows such contributions to be made on a nondeductible basis, and the 10-percent excise tax on nondeductible contributions does not apply to a SIMPLE 401(k) or a SIMPLE IRA solely because the contributions are not a trade or business expense.³¹

²⁸ IRC Section 402(g)(1).

²⁹ IRC Section 402(g)(8).

³⁰ IRC Section 408(p)(4)(A), 408(p)(6)(B).

³¹ IRC Section 4972(c)(6).

Caution: This provision is intended to apply only to employers that have paid and continue to pay all applicable employment taxes, but the statute does not include this limitation.³² Similar provisions were not made for a SEP or a SARSEP covering only a domestic or household worker. Thus, the nondeductible contribution to a SEP or a grandfathered SARSEP may be subject to a 10-percent penalty.³³

Compensation

Compensation used for SIMPLE IRA plan purposes means the sum of the wages, tips, and other compensation from the employer subject to federal income tax withholding and the employee's salary-reduction contributions made under the plan, and if applicable, elective deferrals under a 401(k) plan, a SARSEP, or a IRC Section 403(b) tax-sheltered annuity or custodial account, and compensation deferred under a 457 plan required to be reported by the employer on Form W-2, Wage and Tax Statement.³⁴

For a self-employed individual (including a partner in a partnership), compensation means the NESE determined under IRC Section 1402(a) prior to subtracting any contributions made by the self-employed individual. In computing NESE, that section provides for an in lieu of deduction of 7.65 percent; thus, only 92.35 percent of the NESE (before the application of the in-lieu of deduction) is treated as compensation.

Compensation earned before a new plan's effective date cannot be ignored or prorated.³⁵ This is important in determining the amount of compensation that is considered by the employer in making its contribution. Thus, compensation for the entire calendar year must be used.

Practice Pointer: For years beginning after 2001, the definition of compensation includes an individual's net earnings that would be subject to taxes under the Self-Employment Contributions Act (SECA) but for the fact that the individual is covered by a religious exemption.³⁶

Note. After 2001, if a nonresident alien is a regular member of a crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States, the compensation received by the nonresident alien is not considered U.S. source income for purposes of a SIMPLE IRA (or any qualified retirement plan, including a SEP, a SIMPLE IRA, and a SARSEP).³⁷

³² EGTRRA Section 637; H.R. Conf. Rep. 107-51, pt. 1 (2001).

³³ IRC Section 4972(d)(1)(iv).

³⁴ IRC Sections 408(p)(6)(A), 6051(a)(3), 6051(a)(8).

³⁵ Treas. Reg. Section 1.401(a)(17)-1(b)(3); Notice 98-4, Q&As D-4, I-6 (1998-2 IRB 26).

³⁶ IRC Section 401(c)(2)(A).

³⁷ IRC Section 861(a)(3).

Vesting

Because employees' accounts are maintained in their own IRAs, employees are fully vested in all amounts contributed on their behalf.³⁸

Employee Contributions

An employee may make annual elective contributions of up to \$9,000 for 2004 (\$8,000 for 2003) plus catch-up contributions. Employer contributions (including pretax elective contributions made by employees) are made in SIMPLE IRAs generally established by eligible employees. A traditional IRA may not be used in connection with a SIMPLE of an employer. An employer may not reduce the elective amount that may be contributed to an amount less than \$9,000 plus the \$1,500 catch-up contribution limit for 2004. Elective contributions may be made from amounts that would have otherwise been payable in cash (including bonuses) for the year.

The maximum annual elective deferral limit for a SIMPLE IRA increases from \$7,000 (the 2002 limit) beginning after 2001, as follows:³⁹

Year	Increased Deferral Limit
2002	\$ 7,000
2003	\$ 8,000
2004	\$ 9,000
2005	\$10,000

The elective SIMPLE deferral limit will be increased for cost-of-living adjustments (COLAs) in increments of \$500 after 2005.⁴⁰

Catch-Up Elective Contributions

If a participant in a SIMPLE will attain age 50 by the end of the taxable year, he or she may make an additional elective deferral up to an applicable dollar limit. This catch-up amount is in addition to the normal deferral limit for the applicable year. The maximum amount of a catch-up contribution is the lesser of the participant's compensation for the year or the applicable dollar amount. The applicable dollar amounts are as follows:⁴¹

³⁸ IRC Section 408(a)(4), 408(b)(4).

³⁹ IRC Section 408(p)(2)(E)(i).

⁴⁰ IRC Section 408(p)(2)(E)(ii).

⁴¹ IRC Section 414(v).

Year	Catch-Up Amount
2002	\$ 500
2003	\$1,000
2004	\$1,500
2005	\$2,000
2006	\$2,500

The rates for an employer's matching contribution, or nonelective contribution, have not changed. This means that under a SIMPLE IRA plan, a participant may defer 100 percent of compensation or \$9,000 (\$10,500 if age 50 or older), whichever is less, for 2004. The participant receives either a matching contribution of 3 percent of compensation (or less if permitted) based on his or her total compensation (no \$205,000 ceiling) or a nonelective contribution of 2 percent of compensation based on his or her total compensation (capped at \$205,000).

Example. Tabitha, age 55, participates in her employer's SIMPLE IRA plan. Her compensation for 2004 is \$400,000. Tabitha defers the maximum of \$10,500 for 2004. If her employer matches the amount of her deferrals at 3 percent of compensation, the matching contribution would be \$10,500 ($\$400,000 \times .03 = \$12,000$, but capped at \$10,500), the amount Tabitha deferred. Alternatively, if Tabitha's employer chooses the 2-percent nonelective contribution option, the nonelective contribution to Tabitha's account would be \$4,100 ($\$205,000 \text{ compensation limit} \times .02$).

Termination of Election

An eligible employee must be permitted to terminate a salary-reduction agreement at any time. The termination request must be in writing and become effective as soon as practicable after receipt of the request by the employer or, if later, the date specified in the termination request.⁴²

Amendment of SIMPLE IRA

An amendment to a SIMPLE can be made effective only at the beginning of a calendar year and must conform to the content of the plan notice for the calendar year. Thus, an amendment that conforms to the plan notice may be made effective as of the beginning of that calendar year.

Employer Matching Contributions

An employer must make either a matching contribution or a nonelective contribution, as may be provided in the SIMPLE IRA. No other types of employer contributions are permitted.

⁴² IRC Section 408(p)(5)(B).

An employer is generally required to match the employee's elective contribution on a dollar-for-dollar basis up to a limit of 3 percent of the employee's total compensation for the entire calendar year. The 3-percent limit may be reduced, but not below 1 percent, provided the percentage is not lowered for more than two calendar years out of the last five-year period ending with the calendar year in which the reduction is effective.

Years prior to the plan's effective date are treated as if the 3-percent contribution were made.

Employer Nonelective Contributions

In lieu of making a matching contribution, an employer may elect to make a nonelective contribution of 2 percent of compensation for each eligible employee, regardless of whether the employee elects to make salary-reduction contributions for the calendar year. Nonelective contributions, if selected, must be made on behalf of each eligible employee who has at least \$5,000 of compensation from the employer, whether or not the employee chose salary reduction.⁴³

The compensation cap of \$205,000 (the 2004 limit) applies to nonelective contributions. Thus, the maximum 2004 nonelective contribution amount or limit is \$4,100 ($\$205,000 \times .02$).⁴⁴

Plan Year

SIMPLE IRA plans must be maintained on a calendar-year basis. If the employer's business taxable year is not the calendar year, the deduction for the previous calendar year is postponed until the end of the fiscal year.

Example. The Holly Corporation maintains a SIMPLE plan and has a taxable year that ends on June 30. The contributions made in respect to 2003 will be deductible on Holly's federal corporate income tax return for its tax year ending June 30, 2004.

Deduction of Contributions

An employer may deduct contributions, including employees' elective contributions, for the employer's taxable year within which the calendar year for which the contributions were made ends.

A business may deduct contributions made into SIMPLE IRAs of eligible employees on its business tax return, where the contribution to the SIMPLE IRA is made *after* the business tax return is filed but *before* the due date of the return.⁴⁵ Contributions are treated as made for a taxable year if they are made on account of such taxable year and are made not later than the due date of the business tax return (including extensions).

⁴³ IRC Section 408(p)(2)(B).

⁴⁴ IRC Section 408(p)(2)(B)(ii).

⁴⁵ See Rev. Rul. 84-18 (1984-1 CB 88).

Note. The employer, as is also true of employers making contributions under other salary-reduction plans, such as 401(k) plans, is deemed to have made the contribution on behalf of the employee who elected to reduce salary, and so the employer can take the same deduction that would have applied had the amount been paid to the employee as cash salary, rather than being directed to the SIMPLE IRA in accordance with the employee's instruction. Elective contributions are not included in an employee's gross income.

For the purpose of IRC Section 4972(d), a SIMPLE is treated as a qualified employer plan and is, therefore, subject to the penalty tax on nondeductible contributions. The employer is subject to a 10-percent penalty tax on any excess nondeductible contributions.⁴⁶

Contribution Due Dates

An employer must make matching contributions or nonelective contributions to the employee's SIMPLE IRA by the date that its tax return for the tax year is due (including extensions for the purpose of claiming its deduction. Employee elective contributions must be made to the employee's SIMPLE IRA no later than the thirtieth day of the month following the month in which the amounts would have been payable to the employee in cash (or the amount of earned income in the case of a self-employed individual is determined). Alternatively, if the elective contribution is made sooner, the contribution *must* be made on the earliest date the amount can reasonably be segregated from the employer's general assets.⁴⁷ Special rules may apply to partners in a partnership. See Chapter 19, "Deadlines for Depositing Employee Contributions and Loan Repayments." Employer contributions required for the year, must be deposited by July 15, 2004, the extended due date for the 2003 return.

An employer may deduct the contributions for its taxable year only if the contributions are made by the date (including extensions) the employer's tax return is due. A sole proprietor or a partner in a partnership must also have his or her personal income tax returns extended to the date contributions will be made or later.

Salary-reduction (elective) contributions must be made by the due date of the return (including extensions) to be deductible by the employer, although they may have to be deposited sooner under Employee Retirement Income Security Act of 1974, as amended (ERISA).

Effect on Social Security Benefits

An employer's matching and nonelective contributions to a SIMPLE IRA are not subject to the Federal Insurance Contributions Act (FICA), which determines Social Security contributions, or Federal Unemployment Tax Act (FUTA). Elective contributions to a SIMPLE IRA are excludable from the employee's income and are not subject to federal income tax withholding, but

⁴⁶ IRC Section 4972(a), 4972(d)(1)(A)(iv).

⁴⁷ DOL Reg. Section 2510.3-102(b)(1).

they are subject to FICA, Medicare, railroad retirement, and federal unemployment taxes.

Example. In 2004, Tiger, age 60, was a participant in his employer's SIMPLE. His Form W-2, Wage and Tax Statement, compensation, before SIMPLE contributions, was \$41,600, or \$800 per week. Instead of taking all compensation in cash, Tiger elected to contribute 12.5 percent of his weekly pay (i.e., \$100) to his SIMPLE IRA. For 2004, Tiger's salary-reduction contributions totaled \$5,200, which was less than the normal \$9,000-limit on such contributions for 2004. Under the plan, Tiger's employer is required to make dollar-for-dollar matching contributions to Tiger's SIMPLE IRA. The employer's matching contributions must equal Tiger's salary reductions but cannot be more than 3 percent of Tiger's annual compensation (before salary reduction). Thus, the employer's annual matching contribution to Tiger's SIMPLE IRA was limited to \$1,248 (i.e., 3 percent of \$41,600).⁴⁸

If Tiger were self-employed (e.g., not paid on Form W-2), only 92.35 percent of his self-employment income can be used; thus, his 3-percent contribution would be only \$1,152.53 ($\$41,600 \times .9235 \times .03$). As a self-employed individual, Tiger's *total* contribution, including the dollar-for-dollar matching contribution, would be \$6,352.53 (salary-reduction contributions of \$5,200 + \$1,152.53).

Example. The facts are the same as those in Example 1 except that Tiger's Form W-2 compensation for 2004 was \$300,000, and he chose to have \$10,500 contributed to his SIMPLE IRA. \$1,500 is treated as a catch-up contribution.

Tiger's salary-reduction contribution for the year, \$10,500 is the 2004 limit for individuals age 50 or older. Three percent of Tiger's annual compensation is \$9,000, which is more than the amount his employer was required to match (\$10,500), so Tiger's employer's matching contribution was \$9,000. The total contributions made on Tiger's behalf for the year are \$19,500 (\$10,000 + \$9,500), the maximum contributions permitted under a SIMPLE for 2004.⁴⁹

If Tiger were self-employed (i.e., not paid on Form W-2), only 92.35 percent of his self-employment income could be used. Although Tiger could elect to defer \$10,500, his matching contribution may not exceed \$8,311.50 ($\$300,000 \times .9235 \times .03$). As a self-employed individual, Tiger's total contribution, including the dollar-for-dollar matching contribution, would be \$18,811.50 (\$10,500 + \$8,311.50). Had Tiger's self-employment income been \$378,992.96 and had he contributed \$10,500 for 2004, he would receive the maximum matching contribution of \$10,500 ($\$378,992.96 \times .9235 \times .03$).

Example. The facts are the same as those in the first paragraph of Example 2 except that Tiger's employer chose to make nonelective contributions

⁴⁸ IRC Sections 408(p)(2), 1402(a)(12).

⁴⁹ IRC Sections 408(p)(2), 1402(a)(12).

instead of matching contributions. Because an employer's nonelective contributions are limited to 2 percent of the first \$205,000 of the employee's compensation, Tiger's employer contributed \$4,100 to Tiger's SIMPLE IRA in 2004. The total contributions made on Tiger's behalf for the year were \$14,600 (Tiger's salary reductions of \$10,500 plus his employer's nonelective contribution of \$4,100).

Example. Tony, a self-employed individual with no other employees, has self-employment income of exactly \$4,331.35, resulting in net earnings from self-employment (NESE) of \$4,000. Tony's SIMPLE provides for a matching contribution (up to 3 percent of compensation). Tony's recharacterized compensation is \$3,880 ($\$4,000 \times \$120 (\$4,000 \times .03)$). If Tony contributes \$4,000 and receives a \$120 matching contribution, the excess amount may be subject to a penalty tax. To the extent contributions under a SIMPLE are not deductible by the employer, the employer (including a self-employed individual who is treated as the employer) is subject to a 10-percent nondeductible contribution penalty tax under IRC Section 4972.⁵⁰ Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*, is used for this purpose.

Reporting Requirements

Employers maintaining a SIMPLE IRA plan do not generally have to file any of the Form 5500 series annual return/reports for employee benefit plans. However, an employer must report to the IRS on Form W-2 which employees are active participants in the SIMPLE IRA plan and the amount of the employee's salary-reduction (elective) contribution.⁵¹

Excess Contributions

Excess SIMPLE IRA contributions are created if contributions are made in excess of the amounts permitted or if an employer does not qualify to establish or maintain a SIMPLE IRA plan.⁵² The IRS has not issued formal guidance on excess contributions to a SIMPLE IRA. Form 5329 does not provide for such excesses to be reported on that form (nor does Form 5330 apply) because a SIMPLE IRA is not a traditional IRA, although it is an IRA (just like a SEP or a SARSEP).

Therefore, many financial organizations will not make a corrective distribution from a SIMPLE IRA. Instead, they consider any withdrawal an age-based distribution that is taxable when withdrawn and subject to the 25-percent penalty tax unless an exception applies. (See Chapter 15, "Rollovers and Portability.") These organizations suggest that the excess should either be left in the SIMPLE IRA (apparently they believe that the 6-percent excise tax under IRC Section 4973 is not an issue) or be withdrawn.

⁵⁰ IRC Section 4972(d)(1)(A)(iv), 4972(d)(2)(A).

⁵¹ IRC Sections 408(p)(2), 1402(a)(12).

⁵² IRC Sections 402(k), 408(p)(1).

Excess contributions *timely* distributed from an IRA or SEP IRA are not subject to federal income tax (assuming no prior deduction was taken or the amount was not excluded from income). Thus, excess contributions distributed (with any gain thereon) before the due date of the individual's federal income tax return are not subject to the 10-percent tax upon early distribution even if the owner is under age 59½ at the time of distribution. Arguably, neither the 10-percent nor the 25-percent tax would apply when an excess contribution is timely corrected, inasmuch as the correcting distribution is not subject to taxation under IRC Section 408(d)(4). According to statements made by representatives of the IRS at the National Conference of the American Society of Pension Actuaries (ASPA) in 2000, the 25-percent penalty does not apply if an employer adopts a 401(k) plan invalidating the qualified salary-reduction plan in a SIMPLE.⁵³

Treatment of Excesses

With one exception, none of the guidance issued with respect to SIMPLE IRAs or to other types of excess contributions suggests how excess SIMPLE IRA contributions should be treated or specifies any correction method. Because excess contributions are not deductible, the employer is subject to a 10-percent penalty tax unless the excess is corrected.⁵⁴ An excess amount cannot be used by the employee as a traditional IRA contribution because such contributions must be made to a *traditional IRA*, a term that does not include a SIMPLE IRA.⁵⁵

Apparently the regular IRA excess contribution rules apply to the employees, because a SIMPLE retirement account is “an individual retirement plan [as defined in Section 7701(a)(37)]” that must meet additional rules specified in IRC Section 408(p).⁵⁶

The specific instructions for Form W-2 (2004), box 12, relating to 401(k) plan excesses, provide that the entire elective contribution is reported in box 12 (with code S). The instructions specifically state, “The excess is *not* reported in box 1” [emphasis added]. On the other hand, the instructions on the back of Form W-2 (2004) for completing box 12 state, with respect to code S, “Employee salary-reduction contributions under a section 408(p) SIMPLE (not included in box 1).” Arguably, excess contributions under a SIMPLE are to be reported in box 1 but should not be reflected in box 12. This approach seems to eliminate any employer penalty relating to nondeductible contributions by turning those amounts into personal SIMPLE IRA contributions made by the employee.

Because traditional IRA contributions cannot be made to a SIMPLE IRA, in the authors' opinion, the employee should remove the entire amount in ac-

⁵³ Paul Schultz, Director of Employee Plans, Rulings and Agreements, and Richard J. Wickersham, Chief, Projects, Branch 2, at the IRS Q&As, ASPA National Conference (2000). The statements do not represent the official position of the IRS; they were neither reviewed nor approved by the IRS or the Department of the Treasury.

⁵⁴ IRC Section 4972(d)(1)(A)(iv).

⁵⁵ IRC Section 408(p)(1)(B).

⁵⁶ IRC Section 408(p)(1).

cordance with the general rules for removing excess IRA contributions under IRC Section 408(d)(4) and (5). This approach also seems to eliminate the distinction between excess employer contributions and excess employee contributions, but leaves open the issue of income tax withholding and FICA and FUTA taxes. The employee would have to explain why the amount shown on Form 5498 should not be subject to tax (having also been reported in box 1 of Form W-2).

Note. Rules similar to the SEP participant exclusion rules under IRC Section 402(h) apply to SIMPLE IRAs⁵⁷ but do not specify a limitation on employer contributions. In the authors' opinion, excess contributions are created if contributions are made in excess of the amounts permitted or if an employer does not qualify to establish or maintain a SIMPLE IRA plan.⁵⁸ IRC Section 402(k) does, however, provide that distributions from a SIMPLE IRA are taxable under IRC Section 408(d); thus, in the authors' opinion, the rules of IRC Section 408(d)(4) and (5) apply.⁵⁹

Under its EPCRS, the IRS provides special correction programs for removing certain types of excess amounts.⁶⁰ (For additional information on the voluntary correction programs, see Chapter 12.)

If the traditional IRA rules apply, a distribution of an excess traditional IRA contribution, made within the time for filing the individual's tax return for the year in which the excess traditional IRA contribution was made, is neither included in gross income nor subject to the penalty tax on premature distributions, provided that the interest or other income that was earned on the excess traditional IRA contribution is also withdrawn.⁶¹ The interest or other income attributable to the distribution is taxable in the year the contribution was made and is subject to the premature distribution penalty tax if the participant is under age 59½ (unless another exception applies).⁶²

In general, if the excess traditional IRA contribution is withdrawn after the due date of the individual's tax return for the year and the 6-percent excess contribution penalty tax is paid, the excess amount is not includable in income, regardless of whether the interest or other income earned on the excess contribution is also withdrawn.⁶³ The \$3,000 limit applicable to corrective IRA distributions made after the due date of the return is increased by the amount of the IRC Section 415 dollar limit (currently \$41,000) or the amount of SEP contributions if less; no increase is provided for excess SIMPLE IRA contributions returned after the due date.⁶⁴

⁵⁷ IRC Section 402(k).

⁵⁸ IRC Section 402(k), 408(p)(1).

⁵⁹ IRC Section 402(h)(1), 402(h)(3), 402(k).

⁶⁰ Rev. Proc. 2003-44, Section 6.10(5), 2003-25 IRB 1051. See also Appendix C, "Specimen Application for Compliance Statement Under Revenue Procedure 2003-44 Regarding an Employer Eligibility Failure."

⁶¹ IRC Section 408(d)(4).

⁶² IRC Section 72(t).

⁶³ IRC Section 408(d)(5).

⁶⁴ IRC Section 408(d)(5)(A)(ii).

Arguably, the correction of SIMPLE IRA excesses after the due date for the filing of the individual's federal income tax return would result in double taxation once due to the absence of a contribution exclusion for the excess and again when the correcting distribution is made.

It is unclear whether the 6-percent penalty tax applies to excess SIMPLE IRA contributions. In regard to the 6-percent tax, Form 5329 indicates that it applies to "[a]n IRA" but states, "For purposes of Form 5329, a traditional IRA is any IRA, including a simplified employee pension (SEP) IRA, other than a SIMPLE IRA or Roth IRA." Even if the 6-percent tax were to apply, there is no form on which it can be reported to the IRS because Form 5329 is required to be attached to Form 1040 if there is an entry on line 58. The tax on Form 5329 is zero. As to characterizing the SIMPLE IRA that remains in existence after an excess contribution is made, this is another area in which the IRS has not provided direct guidance.

There are no notification requirements applicable to excesses under a SIMPLE. Even if the entire plan is invalidated as a result of an excess contribution of one cent to a participant's account, it appears that the amount contributed to the SIMPLE IRA does not have to be removed and the assets will grow on a tax-deferred basis. An employer cannot force a corrective distribution from any type of IRA-based plan, such as a SEP, a SARSEP, or a SIMPLE.

Note. It seems evident that the IRS is hesitant to address this issue and other issues relating to the proper administration of the tax laws relating to distributions and the correction of excess contributions. Perhaps this is so because the Code does not provide a remedy. Even if the regular IRA excess contribution rules apply to excess SIMPLE IRA contributions, other issues would need to be resolved. On the payment of a substantial user fee, it might be possible to get an answer by requesting a private letter ruling. It appears that the IRS does not believe that this is a recurring problem, but clearly, after five years, the IRS could have provided some guidance.

Deduction Carryforward

IRC Section 404(m) does not permit an employer to carry forward nondeductible amounts contributed to a SIMPLE IRA (whereas excesses under a SEP can be carried forward).⁶⁵

Time Requirements for Contribution Elections and Notices

Certain time requirements for employee elections and employer notices must be observed for SIMPLE IRAs, as follows:

Employee Elections

During the 60-day period before the beginning of a plan year and during the 60-day period before the employee is eligible to participate (the enrollment period), the employee may choose to contribute either a percentage of compensa-

⁶⁵ See IRC Section 404(h)(1)(C).

tion or a specific dollar amount, or an alternative that the employer prescribes concerning the form of election.

Enrollment Period

The election period is the 60-day period before the beginning of any year and the 60-day period before the employee first becomes eligible to participate. In general, the 60-day period is the statutory period during which an eligible employee may elect to participate or modify a previous election amount.⁶⁶ An employer may allow additional periods for making and changing elections or even lengthen the 60-day enrollment period. Thus, for a calendar year, an eligible employee may make or modify a salary-reduction election during the 60-day period immediately preceding January 1 of that year. For the year in which the employee becomes eligible to make salary-reduction contributions, however, the period during which the employee may make or modify the election is a 60-day period that *includes either the date the employee becomes eligible or the day before*.

The interpretation given the statute allows the 60-day period to include *at a minimum* either:⁶⁷

- The date of eligibility, in which case modifications could be made during the election period while the employee is a participant; or
- The day before an employee becomes eligible, in which case a modification could only be made before participation, unless the plan provides additional election periods.

Election Modification and Cancellation

An employee who commences participation during the election period may cancel or modify a previous election. Any such change is prospective and should be implemented by the employer as soon as is administratively feasible (or, if later, on the date specified by the employee in the salary-reduction agreement).

Example. On November 1, 2003, Tin Company decides to establish its first retirement plan. It adopts a SIMPLE IRA with no service or compensation requirements for its 40 employees. The plan is duly adopted and effective on January 1, 2004. Tin's employees are given a summary description, a model notification to eligible employees, and a model salary-reduction agreement on November 1, 2003. The 60-day period starts on November 2 and ends on December 31, 2003.

Here, the 60-day period includes the day before (December 31) the date the employee becomes eligible. Although contributions can be discontinued at any time, no modifications are permitted after the 60-day election period unless the plan provides for additional opportunities to modify (or make) an election to defer compensation.

⁶⁶ IRC Section 408(p)(5)(C).

⁶⁷ Notice 98-4, Q&A E-1 (1998-2 IRB 26).

Example. In May 2004, Tin Company decides to adopt its first retirement plan. It adopts a SIMPLE IRA with no compensation or service requirements covering its 60 employees. The plan is duly adopted on May 25 but states an effective date of June 1, 2004.

Employees are given a summary description, a model notification to eligible employees, and a model salary-reduction agreement on June 3. The 60-day period starts on June 3. The summary description and other notices must generally be given before the employees' 60-day election period. In this case, however, salary-reduction contributions may start as soon as administratively feasible but not earlier than June 3, the day of notification and delivery of the summary description (see the discussion entitled "Special Rule" that follows). The plan may provide for salary deferrals to start at some later date during the year. In this example, the 60-day period includes the date the employees became eligible (June 3). The employees may make or modify an election during the 60-day period that ends on August 2, 2004.

Example. Wick Company establishes a SIMPLE IRA plan effective as of July 1, 2004. Each eligible employee becomes eligible to make salary-reduction contributions on that date. The 60-day period must begin no later than July 1, 2004. Alternatively, it cannot end before June 30, 2004.

Special Rule

In the case of an employee who becomes an eligible employee other than at the beginning of a calendar year because (1) the plan does not impose a prior-year-compensation requirement, (2) the employee satisfied the plan's prior-year-compensation requirement during a prior period of employment with the employer, or (3) the plan is effective after the beginning of a calendar year, the eligible employee must be permitted to make or modify a salary-reduction election during the 60-day period that *begins on* the day notice of the election is provided to the employee and that includes the day the employee becomes an eligible employee or the day before. In this case, the salary-reduction election will become effective as soon as practical after receipt of notification by the employee (or, if later, on the date specified by the employee in the salary-reduction agreement), but any election made by the employee may be modified prospectively at any time during the 60-day period.⁶⁸ An employee election that is timely made cannot be restricted by the employer except to keep the contribution amount within the legal limit for salary-reduction contributions.

Amendment

Once notices are given to the employee, the employer cannot amend the plan to change the type of contribution it chose to make. Any such amendment is not effective until the beginning of the following year. If the plan is terminated, the employer must make the contributions it specified or lose the de-

⁶⁸ Listing of Required Modifications and Information Package (LRM) for Savings Incentive Match Plan for Employees of Small Employers (SIMPLE IRA Plan) under IRC Section 408(p) (2002), item 6.

duction for its contributions. State law may also require that the employer make its agreed-to contribution.

Employer Notices

Before the beginning of the employee's 60-day election period, each employee must be notified by the employer of the employee's opportunity to make, modify, or terminate a salary-reduction election under a SIMPLE IRA plan and the employer's election to make reduced matching contributions or, alternatively, nonelective contributions. In this way, the employee who wishes to elect salary reduction will do so with the knowledge of how the employer will be determining its contribution. An employer must also furnish its employees with a summary description of the plan and other notifications before the beginning of the 60-day election period. The IRS has provided model plan documents (which are not required to be filed with the IRS), including forms for meeting employer notification requirements, maintaining plan records, and proving that a SIMPLE IRA plan for employees was established.

The choice of form and the manner of its completion will indicate whether the employee participants are allowed to select the financial institutions for receiving their SIMPLE IRA contributions or whether the employer requires that all contributions under the plan be deposited at a designated financial institution.

If the employer uses a designated financial institution for contributions to the SIMPLE IRA plan, each employee must be notified in writing that his or her balance can be transferred without cost or penalty.

Taxation of Distributions

In general, all distributions from a SIMPLE IRA are taxable. If received before age 59½, the amount may also be subject to a 10-percent or 25-percent penalty.⁶⁹ There are a number of exceptions to the early distribution penalty tax if the individual is under age 59½. (See Chapter 15.) If one of the exceptions to the application of the penalty tax applies (e.g., for amounts paid after age 59½, after death, or as part of a series of substantially equal periodic payments), the exception will also apply to distributions within the two-year period, and the 25-percent penalty tax will not apply.

The two-year period begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA. It would appear that each SIMPLE IRA has its own two-year rule.

Withholding

The usual IRA rules apply to withholding.

IRS Reporting

The trustee or custodian is required to report distribution amounts to the IRS on Form 1099-R and provide a copy of the form to the owner of the SIMPLE IRA.

⁶⁹ IRC Sections 72(t), 408(d)(1), 408(p)(1).

Rollovers and Transfers

The usual IRA rules apply to rollovers and trustee-to-trustee (or custodian-to-custodian) transfers. Rollovers must be completed within 60 days of distribution. The property that is rolled over must be the same property that was distributed.

With respect to SIMPLE IRAs, a tax-free rollover may be made from one SIMPLE IRA to another in similar fashion to rollovers between other IRAs of the same type (not more than once in any 12-month period).

A tax-free rollover may also be made from a SIMPLE IRA to a regular IRA, provided that the individual has participated in the SIMPLE IRA plan for the two-year period. Thus, a distribution from a SIMPLE IRA during the two-year period qualifies as a rollover contribution (and is not includable in gross income) only if the distribution is paid into another SIMPLE IRA and satisfies the other requirements for treatment as a rollover contribution.

Example. In 2004, Marbles Ltd. establishes a SIMPLE IRA plan covering two employees, Molly and George, both age 39. Both employees separate from service in 2005, having made no rollovers and having received no distributions. Molly rolls over the funds in her SIMPLE IRA account to a traditional IRA; George rolls over the funds in his account into a SIMPLE IRA maintained by his new employer, the Diamond Company. In both cases, rollovers are made within the two-year period. Molly's rollover is invalid because it was not made to a SIMPLE IRA. Thus, the rollover amount is a taxable distribution.

In addition, Molly is liable for the 25-percent penalty tax. Furthermore, the amount she rolled over to her traditional IRA may be an excess contribution, if the annual limit of \$3,000 plus catch-up contributions for 2003 is exceeded. George's rollover is valid, so there are no tax consequences. Even if Diamond Company did not offer a SIMPLE IRA, George could have rolled over his funds into Marble Ltd.'s SIMPLE IRA into a SIMPLE IRA that he could establish.

Distributions made after 2001 from an individual's SIMPLE IRA (after the two-year period applicable to SIMPLE IRAs has expired) may be rolled over into a qualified plan or annuity, traditional IRA, 403(b) annuity or custodial account plan, or governmental 457(b) plan. This rule applies to all amounts in a SIMPLE IRA. This rule does not apply to any amounts in a Roth IRA or a Coverdell education savings account.⁷⁰ Rollovers and transfers are more fully discussed in Chapter 15.

Subject to the "one rollover per 12-month period" rules, an individual may receive a distribution and roll over or transfer all or a portion of the amount received into another SIMPLE IRA, or after the two-year rule is satisfied, a traditional IRA. In the case of property, the identical property must be rolled

⁷⁰ IRC Section 408(d)(3)(A), 408(d)(3)(D)(i).

over. Any amount not rolled over (or transferred) is subject to federal income tax, and if the employee is under age 59½, a 10-percent or 25-percent early distribution penalty tax may apply.

ERISA Requirements

For purposes of Section 404(c) of the ERISA, a participant or beneficiary in a SIMPLE IRA will be treated as exercising control over the assets in his or her account on the earliest of one of the following:

- An affirmative election among investment options with respect to the initial investment of any contribution
- A rollover to any other SIMPLE retirement account or IRA
- One year after the SIMPLE retirement account is established

Bonding

In most cases, an employer that handles funds or other property that belongs to an ERISA plan (including a SEP or SIMPLE) is required to be bonded. The basic standard is determined by the possibility of risk of loss in each situation; thus, it is based upon the facts and circumstances in each situation. The amount of such bond, which is determined at the beginning of each year, cannot be less than 10 percent of the amount of funds handled. The minimum bond is \$1,000. However, contributions made by withholding from an employee's salary are not considered funds or other property of a SIMPLE (or SEP) for purposes of the bonding provisions so long as they are retained in and not segregated in any way from the general assets of the withholding employer. Because employer contributions are made into SIMPLE IRAs established by each employee (which are outside the control of an employer once made), bonding would not generally apply.⁷¹

Summary Description

The trustee of the SIMPLE is required to provide to an employer, each year, a summary description containing the following information:

- Name and address of the employer and the trustee
- Eligibility requirements for participation
- Benefits provided
- Time and method of making employee elections
- Procedures for and effects of withdrawals (including rollovers) from the arrangement

In general, an employer must notify each employee, immediately before the period for which an employee election may be made, of his or her opportunity to make the election and include a copy of the above description if re-

⁷¹ ERISA Sections 404(c), 412; DOL Reg. Sections 2510.3-3, 2550.412-5.

ceived from the trustee. This is the only report required of an employer that maintains a SIMPLE.⁷²

In addition, a trustee must give each participant, within 31 days after the end of each calendar year, a statement showing the account activity during the year and the account balance at the close of the year. The trustee is also required to make reports to the IRS on Form 5498.⁷³

Elective Contributions

Elective contributions to an employee's SIMPLE IRA must be made no later than the thirtieth day of the month following the month in which the amounts would have been distributed to the employee in cash but for the election or, if sooner, the earliest date the amounts can reasonably be segregated from the employer's general assets.⁷⁴ The 30-day rule is not a safe harbor.

Retirement Planning Advice

EGTRRA clarifies that retirement planning advice provided to employees (and their spouses) after 2001 on an individual basis is a nontaxable fringe benefit to the extent such advice is made available on substantially equivalent terms to all employees.⁷⁵

Tax Credits

Tax Credit for Employers

A small business that adopts a new SIMPLE can generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The tax credit for employers is more fully discussed in Chapter 1, "Introduction."

Tax Credit for Employees

For the five taxable years beginning after 2001 (i.e., 2002 through 2006), certain individuals may receive a nonrefundable low-income taxpayer contribution credit for a percentage of their contributions. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a SIMPLE IRA. The credit is in addition to any other tax benefit (e.g., possible tax deduction) that the contribution gives the taxpayer.⁷⁶ The tax credit for employees is more fully discussed in Chapter 1.

SIMPLE IRA Advantages and Disadvantages

The advantages of SIMPLE IRAs are that they:

- Are easy to establish.
- Are easy to understand and communicate to employees.

⁷² IRC Section 408(1)(2)(A)B(C).

⁷³ IRC Section 408(i), as amended by Tax Reform Act of 1997 (TRA Section 97) Section 1601(d)(1)(A).

⁷⁴ DOL Reg. Section 2510.3-102.

⁷⁵ IRC Section 132(a)(7), 132(m)(1).

⁷⁶ IRC Section 25B(a), 25B(b).

- Have limited fiduciary liability.
- Are subject to minimal reporting requirements.
- Are cost-effective.
- Have no nondiscrimination testing.
- Are subject to no minimum participation requirements.
- Are vested 100 percent and immediately.

SIMPLE IRAs also have a number of disadvantages, as follows:

- Annual employer contribution is required.
- The maximum salary-reduction (elective) contribution is limited to \$9,000 plus catch-up contributions (\$1,500 maximum) for 2004.
- Compensation for nonelective contributions is limited to \$205,000 for 2004.
- Employer contributions are limited to 3 percent of each participant's compensation.
- The employer may not generally maintain any other type of retirement plan.
- A twenty-five-percent penalty may apply to distributions removed within the first two years from the date the SIMPLE was established by the employer.
- Life insurance may not be held in a SIMPLE IRA.
- Loans are not permitted.
- Leased employees must be covered.
- Creditors of employee may be able to gain access to SIMPLE IRA assets.
- Employees are not required to be employed on the last day of the year.
- No lump-sum distribution or five-year averaging of capital gains is allowed.
- Unlike for qualified plans, there is no exception from the early distribution tax for distributions (1) after separation from service after attaining age 55, (2) for deductible medical expenses, or (3) to alternate payees under a qualified domestic relations order. On the other hand, the early distribution tax exception for periodic payments applies whether or not the individual has separated from service, whereas for qualified plans that exception applies only for payments beginning after the employee's separation from service.

401(k) SIMPLE Plans

A 401(k) SIMPLE plan is a qualified 401(k) plan that adopts some of the SIMPLE rules to satisfy annual nondiscrimination tests. SIMPLE is the acronym for savings incentive match plan for employees.

A 401(k) SIMPLE plan maintained by an eligible employer is treated as satisfying the participation and discrimination standards of the IRC provided the arrangement satisfies special rules relating to contributions and vesting and is the only plan of the employer.⁷⁷

Although the 401(k) SIMPLE rules are in IRC Section 401(k)(11), subparagraph (D) of that section states that, “any term used in this paragraph which is also used in section 408(p) shall have the meaning given such term by such section.” Thus, some of the 401(k) SIMPLE rules are borrowed from and are the same as the rules for SIMPLE IRAs previously discussed in this chapter.

The 401(k) SIMPLE rules apply to plan years beginning after December 31, 1996.⁷⁸

Because of the limits, restrictions, and complexities of a 401(k) SIMPLE plan, some commentators believe it unlikely that many employers will establish SIMPLEs in 401(k) form. In the authors' opinion, other types of 401(k) plans (e.g., safe harbor 401(k) plans) are more suitable for most employers.

Plan Year

The plan year of a plan containing 401(k) SIMPLE provisions must be the calendar year. Thus, an employer maintaining a 401(k) plan on a fiscal-year basis must convert the plan to a calendar year in order to adopt 401(k) SIMPLE provisions.⁷⁹

Qualification Requirements

Nearly all of the qualification requirements of the IRC continue to apply to a plan that adopts 401(k) SIMPLE provisions, including the following:

1. The contribution limits of IRC Section 415 (100%/\$41,000 plus catch-up contributions) must be met.
2. The compensation limit (\$205,000 for 2004) of IRC Section 401(a)(17) must be met.
3. The plan as amended must operate in accordance with its terms.

In addition, all other requirements applicable to 401(k) plans continue to apply, including the following:

4. The distribution restrictions of IRC Section 401(k)(2)(B), which generally prohibit elective contributions from being distributed before a participant's severance from employment, attainment of age 59½, death, disability, or hardship

⁷⁷ IRC Section 401(k)(11)(A).

⁷⁸ IRC Section 401(k)(11), 401(m).

⁷⁹ IRC Section 401(k)(11)(D)(i); Rev. Proc. 97-9, Section 2.04 (1997-1 CB 624); Rev. Proc. 87-27 (1987-1 CB 769), regarding automatic approval of certain changes in accounting periods for qualified plans and trusts.

5. The general prohibition set forth in IRC Section 401(k)(4)(B) against state and local governments' maintaining a 401(k) plan

Vesting

All contributions (adjusted for gains and losses) made under a 401(k) SIMPLE plan must be fully vested (nonforfeitable) at all times.⁸⁰ Contributions not made under the SIMPLE rules in other years may continue under existing or other qualified plan vesting rules.

Employer Eligibility

Generally, a 401(k) SIMPLE plan may be established only by an employer that had no more than 100 employees (the 100-employee limit) who earned \$5,000 or more in compensation during the preceding calendar year.⁸¹ There is a two-year grace period if an eligible employer ceases to be eligible in a subsequent year. For purposes of the 100-employee limit, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE.

Note. The 100-employee limit for a 401(k) SIMPLE plan is the same as the 100-employee limit for a SIMPLE IRA plan.

A tax-exempt employer may maintain a 401(k) SIMPLE plan after 1996. A governmental entity (other than an Indian tribal government), on the other hand, may not maintain a SIMPLE in the form of a 401(k) plan. It should be noted, however, that the IRC does not expressly prohibit tax-exempt organizations or government employers from establishing a SEP plan or SIMPLE IRA plan.⁸²

An employer maintaining a 401(k) SIMPLE plan that fails to be an eligible employer may continue to maintain the plan for two years following the last year in which it was eligible.⁸³

Further, if the failure to satisfy the 100-employee limit is the result of an acquisition, disposition, or similar transaction involving the employer, the qualified plan transition rule for coverage if there is an acquisition or disposition replaces the two-year grace period; that is, the grace period runs through the end of the year following the acquisition or disposition.⁸⁴

Exclusive Plan Requirement

Like a SIMPLE IRA plan, a 401(k) SIMPLE plan must be the only *qualified plan* of the employer. If the employer maintains another qualified plan, that

⁸⁰ IRC Section 401(k)(11)(A)(iii).

⁸¹ IRC Sections 401(k)(11)(A), 401(k)(11)(D), 408(p)(2)(C)(i)(I).

⁸² See IRC Section 401(k)(4)(B)(ii); G.S. Lesser, *457 Answer Book*, 3rd Ed., Qs 2:15 and 2:16 (New York: Panel Publishers, 2004).

⁸³ Rev. Proc. 97-9, Appendix Section 1.2(a) (1997-1 CB 624).

⁸⁴ IRC Section 408(p)(2)(C)(i)(II), 410(b)(6)(C).

plan must be frozen or terminated.⁸⁵ It should also be noted that an employer may not maintain more than one SIMPLE plan.

The Technical Corrections Act of 1998 provides for a uniform grace period during which a 401(k) SIMPLE plan may be maintained following an acquisition, disposition, or other similar transaction that affects the employer's ability to meet the following requirements:

1. The 100-employee limit
2. The exclusive plan requirement
3. The plan coverage and eligibility rules

Practice Pointer: If an employer with a 401(k) SIMPLE plan fails to meet any of the above requirements because of an acquisition, disposition, or other similar transaction, the plan may be maintained for a transition period that begins on the date of the transaction and ends on the last day of the second calendar year following the calendar year in which the transaction occurs. For the grace period to apply, coverage under the plan may not be significantly changed during the transition period.

For a 401(k) SIMPLE plan to be maintained during the transition period, it must meet the above requirements following the transaction as if the employer maintaining the plan had remained a separate employer.

Employee Eligibility

Employee eligibility for a 401(k) SIMPLE plan is based on qualified plan rules, under which, for example, an employee may be eligible after the completion of one year of service (generally, 1,000 hours) and attainment of age 21. Any employee who is eligible to make elective deferrals under the regular 401(k) plan rules is eligible to participate in the 401(k) SIMPLE plan. As is the case with a SIMPLE IRA plan, collectively bargained employees, nonresident alien employees, and so on, may be excluded from participating in a 401(k) SIMPLE plan.⁸⁶

Contributions for Household Workers

An employer may make a contribution on behalf of each domestic (and similar) worker other than the employer or a member of the employer's family. The employer's contributions, however, do not qualify for a deduction, because the contributions are not made in connection with a *trade or business*. For taxable years beginning after 2001, the 10-percent excise tax on nondeductible contributions does not apply to 401(k) SIMPLE or SIMPLE IRA plan contri-

⁸⁵ IRC Section 401(k)(11)(A)(ii), 401(k)(11)(C).

⁸⁶ Rev Proc 97-9, Appendix Section 2.2 (1997-1 CB 624).

butions, simply because the contributions are not a trade or business expense.⁸⁷

Note. IRC Section 4972(c)(6) is intended to apply only to employers that have paid and continue to pay all applicable employment taxes.⁸⁸

Exclusive Plan Requirement

An employee may participate in a SIMPLE plan of one employer and in a SIMPLE plan or qualified plan of another employer without violating the exclusive plan requirement, provided the employers are unrelated. In such a case, the total elective deferrals that can be made under more than one plan generally may not exceed \$13,000, plus catchup contributions for 2004.⁸⁹

Contributions made under a 457 plan do not violate the only-plan-of-the-employer rule because such a plan is not a qualified plan, and is not treated as a qualified plan for the purpose of denying SIMPLE contributions. The dollar limit under an eligible 457(b) plan (generally \$13,000 for 2004) is not reduced by the amount of elective employer contributions deferred by the employee under the 401(k) SIMPLE plan for years after 2001.⁹⁰

Compensation

The SIMPLE IRA plan definition of compensation is used for a 401(k) SIMPLE plan.

Contributions

Under a qualified plan containing 401(k) SIMPLE provisions, each employee may elect to make salary-reduction contributions of up to \$9,000 (\$10,500 with a catchup contribution if age 50 or over) for 2004. For 2004, the employer must make either a matching contribution or a nonelective contribution, as follows:

1. *Matching contribution.* Each year, the employer makes a matching contribution to the plan on behalf of each employee who makes a salary-reduction election. The amount of the matching contribution is equal to the employee's salary-reduction contribution (up to \$9,000/\$10,500), up to a limit of 3 percent of the employee's compensation for the full calendar year.
2. *Nonelective contribution.* For any year, instead of a matching contribution, the employer may choose to make a nonelective contribution of 2 percent of compensation (up to \$4,100 for 2004⁹¹) for the full calen-

⁸⁷ IRC Section 4972(c)(6).

⁸⁸ EGTRRA Section 637; see HR Rep No. 107-51, pt 1 (2001).

⁸⁹ IRC Section 402(g)(1), 402(g)(3)(D).

⁹⁰ IRC Section 457(c)(2)(B)(i).

⁹¹ \$205,000 times .03 = \$4,100.

dar year for each eligible employee who received at least \$5,000 (or less if elected) of compensation from the employer for the year.

An employer does not have the option under a 401(k) SIMPLE plan of reducing the matching contribution to less than 3 percent of an employee's compensation.⁹² Such an option does exist for a SIMPLE IRA plan.

No other types of contributions are permitted.⁹³

Contribution Limits

The elective deferral limit for a 401(k) SIMPLE plan will increase from \$7,000 for 2003, as follows:

Year	Increased Deferral Limit
2003	\$ 8,000
2004	\$ 9,000
2005	\$10,000

After 2005, the elective 401(k) SIMPLE plan deferral limit will be increased for COLAs in increments of \$500.⁹⁴

In addition, if a participant in a 401(k) SIMPLE plan reaches age 50 by the end of the calendar year, he or she may make an additional elective deferral. The amount of this catch-up contribution is in addition to the normal deferral limit for the applicable year.

The maximum amount of a catch-up contribution is the lesser of the participant's compensation for the year or the applicable dollar amount.⁹⁵ The applicable dollar amounts are as follows:

Year	Normal Limit	Applicable Catch-Up	Total Deferral
1997–2000	\$ 6,000	n/a	\$ 6,000
2001	\$ 6,500	n/a	\$ 6,500
2002	\$ 7,000	\$ 500	\$ 7,500
2003	\$ 8,000	\$1,000	\$ 9,000
2004	\$ 9,000	\$1,500	\$10,500
2005	\$10,000	\$2,000	\$12,000
2006	\$10,000	\$2,500	\$12,500

⁹² IRC Section 401(k)(11)(B).

⁹³ IRC Sections 401(k)(11)(B), 401(k)(11)(B)(i)(III).

⁹⁴ IRC Section 408(p)(2)(A)(ii), 408(p)(2)(E).

⁹⁵ IRC Section 414(v).

This means that a 401(k) SIMPLE plan participant who is age 50 or over by the last day of participant's taxable year (generally December 31) may defer 100 percent of compensation or \$10,500, whichever is less, for 2004. The employer may choose to make a 3 percent of compensation matching contribution based on the participant's total compensation or a 2 percent of compensation nonelective contribution based on the participant's total compensation. In both cases, compensation is capped at \$205,000.

Contributions to a 401(k) SIMPLE plan may not be reduced or increased by taking into account Social Security or other similar contributions.⁹⁶

The 100 percent of taxable compensation limit under IRC Section 415 (25 percent before 2003) applies to a 401(k) SIMPLE plan, although it does not apply to a SIMPLE IRA plan. Furthermore, the employer's deduction for contributions made to a 401(k) SIMPLE, including salary-reduction contributions, is not limited to 25 percent of the participant's aggregate compensation under IRC Section 404.⁹⁷

A salary-reduction election may not apply to compensation that an employee received, or had a right to immediately receive, before execution of the salary-reduction agreement or election. A participant in a 401(k) SIMPLE plan may discontinue contributions at any time during the calendar year.⁹⁸

Discrimination Testing

For a year in which the SIMPLE rules are used to satisfy nondiscrimination standards, the nondiscrimination tests applicable to elective deferrals and matching contributions will be satisfied provided all SIMPLE contributions are fully vested, and the employer makes the required contribution.⁹⁹ Thus, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test applicable to matching contributions unless the employer fails to make SIMPLE contributions. A 401(k) plan that includes 401(k) SIMPLE provisions is not treated as top heavy under IRC Section 416.

Form W-2 Reporting

Salary-reduction contributions to a 401(k) SIMPLE plan must be reported on Form W-2, Wage and Tax Statement.¹⁰⁰ On Form W-2, a code must be used to designate amounts reported in box 12. Code D is used to report salary-reduction contributions made under a 401(k) SIMPLE plan. Like other types of contributions made to qualified plans, matching and nonelective (i.e., employer) contributions are not required to be reported on Form W-2.¹⁰¹

⁹⁶ IRC Section 401(k)(3)(B).

⁹⁷ IRC Section 404(a)(3)(A)(i), 404(a)(3)(A)(ii), 404(n).

⁹⁸ IRC Section 408(p)(5)(B).

⁹⁹ IRC Section 401(k)(11)(A), 401(k)(11)(B).

¹⁰⁰ Notice 98-4, Q&A I-1 (1998-2 IRB 26).

¹⁰¹ Notice 98-4, Q&A I-1 (1998-2 IRB 26).

Contribution Deduction

Within limits, contributions (including elective contributions made by employees) are deductible by the employer for its business taxable year that includes or coincides with the last day of the plan year, which is always December 31 in the case of a SIMPLE. Thus, if a taxpayer with a fiscal tax year ending June 30 adopts a 401(k) SIMPLE plan for 2004, the taxpayer may claim a deduction for 2004 contributions on its business tax return for the period ending June 30, 2005.¹⁰²

Practice Pointer: For deduction purposes only, employer matching or nonelective contributions to a 401(k) SIMPLE plan must be made on or before the date the employer's federal income tax return is due (including extensions).¹⁰³

Elective contributions are assets of a 401(k) SIMPLE plan. The employer must promptly transmit any employee salary-reduction contributions to the plan's trust on the earliest date such contributions can reasonably be segregated from the employer's general assets, but not later than the fifteenth business day of the month following the month in which the contributions were withheld or received by the employer.¹⁰⁴ The 15-day rule, it should be noted, is not a safe harbor.

Distributions

All 401(k) plans, including those that are SIMPLEs, must limit in-service distributions of elective contributions.¹⁰⁵ Except for loans, distributions to participants and beneficiaries of amounts attributable to elective deferrals may not be made to participants and beneficiaries earlier than upon any of the following:

1. Death
2. Disability
3. Severance from employment (before 2002, separation from service)
4. For distributions made before 2002, the disposition of 85 percent or more of the employer's assets to an unrelated corporation, provided the employee continues employment with the purchaser
5. The disposition of the employer's subsidiary to an unrelated entity (or individual), provided the employee continues employment with the subsidiary
6. The employee's hardship

¹⁰² IRC Section 404(a)(3).

¹⁰³ IRC Section 404(a)(6).

¹⁰⁴ DOL Reg Section 2510.3-102; see, too, chapter 19.

¹⁰⁵ IRC Section 401(k)(2)(B), 408(k)(10); Rev Proc 97-9, Appendix Section 2.06 (1997-1 CB 624).

7. The termination of the plan, provided a lump sum distribution is received

Separation from service occurred only upon a participant's discharge, retirement, resignation, or death. It did not occur if the employee continued on the same job for a different employer as a result of a consolidation, merger, liquidation, or some other corporate transaction.

Severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under the *same desk rule*, a participant's severance from employment does not necessarily result in a separation from service.¹⁰⁶

Generally, distributions from a 401(k) SIMPLE plan are taxable as ordinary earned income and thus are subject to federal income tax withholding. The withholding rate is 20 percent.¹⁰⁷

Individuals born before 1936 may be able to use the special 10-year income averaging method of computing the tax on a qualifying lump-sum (non-periodic) distribution. Five-year income averaging has been repealed for years after 1999.¹⁰⁸

Hardship withdrawals from a 401(k) SIMPLE plan are permitted upon the request of a participant if (1) the participant has an "immediate and heavy financial need" and (2) other resources are not reasonably available to meet the need.

Withdrawals for medical expenses, tuition and related educational expenses, costs related to the purchase of a principal residence, and payments necessary to prevent eviction or foreclosure have all been deemed by the IRS to satisfy the immediate and heavy financial need requirement.¹⁰⁹

Hardship withdrawals are taxable and may be subject to a 10-percent premature distribution penalty unless the participant is age 59½ or older.

Note. The period during which an employee is suspended from making elective contributions (and after-tax contributions) following a hardship distribution was reduced from 12 months to 6 months.¹¹⁰

The 25-percent penalty for distributions made within the first two years of the employee's participation in a SIMPLE IRA does not apply to a SIMPLE in the form of a 401(k) plan.¹¹¹

¹⁰⁶ Rev Rul 79-336 (1979-2 CB 187).

¹⁰⁷ IRC Section 3405(b), 3405(e)(1); Treas. Reg. Section 35.3405-1.

¹⁰⁸ IRC Section 402(d), 402(e)(4)(D).

¹⁰⁹ Treas. Reg. Section 1.401(k)-1(d)(2).

¹¹⁰ Treas. Reg. Section 1.401(k)-1(d)(2)(iv)(B).

¹¹¹ IRC Section 72(t)(6).

Because IRA distribution rules do not apply to 401(k) SIMPLE plans, distributions may commence after age 70½ if the participant is employed at that time and is not a 5-percent owner.¹¹²

Rollovers and Transfers

All the regular rollover rules apply to 401(k) SIMPLE plans. Thus, a participant who receives a distribution from a 401(k) SIMPLE plan may generally defer tax on the taxable amount received by rolling it over within 60 days of receipt to another qualified employer-sponsored plan or to an IRA. A SIMPLE IRA may not, however, be used to receive a rollover from a qualified plan, including a 401(k) SIMPLE plan.¹¹³ Rollovers and transfers are more fully discussed in Chapter 15.

Plan Correction Procedures

All the remedial correction programs offered by the IRS under the EPCRS, see Chapter 12, can be used for a 401(k) SIMPLE plan because it is a qualified plan under IRC Section 401(a).¹¹⁴

In the absence of well-established guidance, the position of the IRS regarding excess contributions to a SIMPLE 401(k) plan is, at best, unclear. Several possibilities exist, some of which offer solutions:

1. The plan becomes a traditional 401(k) plan and is taken out of the realm of a 401(k) SIMPLE plan. In the authors' opinion, this is an unlikely choice because of the information provided to the participant by the plan regarding the manner in which the plan would operate for that plan year.
2. The plan becomes a "bad" SIMPLE plan or a plan with a "bad" contribution allocation. Correction should be made under the EPCRS.
3. It may be possible to correct the excess contribution if plan contributions are the result of a mistake of fact.¹¹⁵ In the authors' opinion, this option is least likely; furthermore, the IRS has not included excess SIMPLE contributions among clear mistakes of fact.
4. It may be possible to correct the excess contribution (in accordance with plan provisions) if plan contributions are conditioned on their deductibility and the deduction for the contributions is subsequently denied.¹¹⁶
5. In May 1999, the IRS informally agreed with propositions 2 and 4 above.¹¹⁷

¹¹² IRC Section 401(a)(9)(C)(i), 401(a)(9)(C)(ii)(II).

¹¹³ See SIMPLE IRA Listing of Required Modifications (LRM) and Information Package (March 2003).

¹¹⁴ Rev Proc 2003-44 (2203-25 IRB 1051).

¹¹⁵ ERISA Section 403(c)(2)(A).

¹¹⁶ ERISA Section 403(c)(2)(C), IRC Section 4972(c)(2).

¹¹⁷ General Information Letter issued to Gary S. Lesser, May 18, 1999; see also Rev Rul 91-4 (1991-1 CB 57).

Practice Pointer: Practitioners should proceed with caution when addressing excess contributions to a 401(k) SIMPLE plan and check for recent guidance provided by the IRS.

Tax Credits

As of 2002, a small business that adopts a new 401(k) SIMPLE plan may generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The credit is available only to employers that did not have more than 100 employees with compensation in excess of \$5,000 during the previous tax year. The employer must also have had at least one nonhighly compensated employee (NHCE). The credit is taken as a general business credit on the employer's business tax return. The other 50 percent of the expenses may be taken as a business deduction. The expenses must be paid or incurred in taxable years beginning after 2001 and with respect to plans established after 2001.¹¹⁸

For the five taxable years beginning after 2001 (i.e., 2002 through 2006), there is a low-income taxpayer credit that allows certain individuals to receive a nonrefundable tax credit for a percentage of their contributions to a 401(k) SIMPLE plan. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a traditional IRA or a Roth IRA, elective deferrals made to a SIMPLE, a SEP, a 401(k) plan, a 403(b) plan, or a 457(b) plan, and voluntary after-tax contributions to a qualified plan. The credit is in addition to any other tax benefit (i.e., the potential tax deduction) that the contribution affords the taxpayer.¹¹⁹ The credit is more fully discussed in Chapter 2, "Simplified Employee Pension Plans—SEP and SARSEP."

¹¹⁸ IRC Section 45E.

¹¹⁹ IRC Section 25B(a)-25B(b).

Exhibit 3-1. SIMPLE IRA Checklist for 2004

Every year it is important to review the requirements for operating a SIMPLE IRA plan. This SIMPLE IRA Plan Checklist has been designed as a quick tool to help keep your SIMPLE IRA plan in compliance with important tax rules. This SIMPLE IRA Plan Checklist is not a complete description of all the requirements and it is not a substitute for a comprehensive plan review.

	YES	NO
1. Did your business have <u>100 or fewer employees</u> during prior year? <i>(Businesses with more than 100 employees - including full-time, part-time, and seasonal employees - who earned at least \$5,000 cannot establish a SIMPLE IRA plan.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
2. Is this SIMPLE IRA plan your business's <u>only employee retirement plan</u> ? <i>(A sponsor of a SIMPLE IRA plan generally cannot sponsor any other retirement plan, such as a 401(k) plan.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have you identified all of your <u>eligible employees</u> ? <i>(Any employee with at least \$5,000 in compensation in 2 prior years and is expected to earn at least \$5,000 this year is eligible to participate in a SIMPLE IRA plan.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
4. Did you <u>notify your eligible employees</u> of their right to elect salary reduction or to modify a prior salary reduction agreement? <i>(Employees must be given notice before November 2 each year of their right to participate in the plan in the next year or change a prior salary reduction agreement.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
5. Have you given all of your eligible employees <u>a copy of the SIMPLE IRA plan agreement</u> (Form 5304-SIMPLE or Form 5305-SIMPLE, if you use the model forms)? <i>(Instead, you can give your employees a "summary description." This document must describe the basic features of the plan, information about the employer and trustee, eligibility requirements, etc.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
6. If you changed your plan, did you <u>give your employees notice of any changes</u> before November 2 for changes taking effect in the following calendar year? <i>(Employees must be given notice of any plan changes at least 60 days prior to the start of the next calendar year.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
7. Have you allowed employees to terminate their <u>salary reduction election</u> ? <i>(Employees must be allowed to stop making deferrals at any time.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
8. Have you <u>deposited</u> employee deferrals timely? <i>(Employee deferrals (amounts that employees elect to contribute by salary reduction) must be deposited in the IRA as soon as possible but in no event later than 30 days following the month in which the employee would have otherwise received the money.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
9. Did you timely <u>deposit the required employer contributions</u> into the SIMPLE IRAs? <i>(Employers have until the due date - including extensions - of their tax return for the tax year that includes the last day of the calendar plan year to deposit matching contributions or employee deferrals.)</i>	<input type="checkbox"/>	<input type="checkbox"/>
10. Are employee deferrals to SIMPLE IRAs <u>limited</u> as required by law? <i>(The contribution limit to a SIMPLE IRA is \$9,000 in 2004. Catch-up contributions for participants aged 50 or over are limited to an additional \$1,500 for 2004.)</i>	<input type="checkbox"/>	<input type="checkbox"/>

If you answered "No" to any of the above questions, you may have made a mistake in operating your SIMPLE IRA plan. For employer use only; do not file this form with IRS.

Source: www.irs.gov (modified by author).

Chapter 4

Qualified Plan in General

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Qualified Plan in General

If the qualification requirements set forth in the Internal Revenue Code (IRC or the Code) are satisfied, a qualified plan may offer the employer (and participants) certain advantages and disadvantages. Small employers, however, may find that the baggage associated with establishing and maintaining a qualified plan outweighs the advantages.

Qualified Plan Advantages

Assuming the qualification requirements set forth in the IRC are satisfied, a qualified plan may offer the following advantages:

1. Contributions are deductible within appropriate limits even though the employees are not currently taxed on these contributions.¹
2. Benefits, whether or not forfeitable, are not included in the employee's gross income until benefits are distributed. Distributions are taxed in accordance with IRC Section 72 relating to annuities.²
3. The assets accumulated in the plan's trust, custodial accounts, or annuities, generally compound on a tax-free income basis. An exception is made, however, for unrelated business taxable income in excess of the \$1,000 specific exemption amount.³
4. Annuity, periodic, and installment payments are taxable only as received. (See Chapter 14, "Taxation of Retirement Plan Distributions."⁴)
5. Employers with fewer than 100 employees earning compensation over \$5,000 per year may be able to claim a business tax credit equal to 50 percent of qualified startup costs of an eligible employer plan. The

¹ IRC Sections 402, 404.

² IRC Sections 402(a), 403(a).

³ IRC Sections 501(a) and (b), 511, 512(b).

⁴ IRC Section 72.

maximum credit is \$500 per year, which may be taken for up to three years. (See Chapter 1, "Introduction."⁵)

6. Distributions may be eligible for rollover or special tax treatment. (See Chapters 14; 15, "Rollovers and Portability;" and 16, "State Taxation of Nonresidents.")
7. There is greater protection from creditors. (See Chapter 17, "Creditor Protection.")
8. Employers may also find that qualified plans:
 - a. Attract and retain qualified employees.
 - b. Encourage loyalty among employees by the use of vesting schedules.
 - c. Serve as a competitive advantage when hiring new employees.
 - d. Can be designed on a tax efficient basis, notwithstanding that employer derived contributions may have to be shared among eligible employees.
9. To reduce a duplication in employer provided benefits, contributions may be integrated with Social Security contributions. (For a discussion of *permitted disparity*, see Chapter 7, "Permitted Disparity—Integration of Defined Contributions."⁶) Plan contributions favor higher paid employees when permitted disparity is utilized.

Practice Pointer: With sufficient compensation, the maximum annual contribution that may be made to a participant (\$41,000, plus catch-up contributions if age 50 or older for 2004) is achievable in an integrated qualified plan. However, the \$41,000 limit has to be reduced (see Chapter 7) in the case of a highly-compensated employee (HCE) under a simplified employee pension plan (SEP) if the SEP utilized permitted disparity. The reduction cannot exceed \$5,101.30.⁷ Compared to a qualified plan's limit of \$41,000 (plus catch-up contributions), only \$35,989.70⁸ may be contributed to a SEP plan when the plan is integrated at the taxable wage base amount; a frequently used level.

SEP and savings incentive match plan for employees (SIMPLE) plans are more fully discussed in Chapters 2, "Simplified Employee Pension Plans—SEP and SARSEP," and 3, "SIMPLE Plans."

⁵ IRC Section 25E.

⁶ IRC Sections 401(l), 402(h)(2)(B); 408(k)(3)(D).

⁷ \$87,900 (the 2004 taxable wage base) X .057 (maximum permitted disparity rate).

⁸ Plus catch-up contributions if permitted under a grandfathered SARSEP. At lower integration levels, higher contributions are permitted to be made for an HCE.

Qualified Plan Disadvantages

Small employers, especially, may find that the baggage associated with establishing and maintaining a qualified plan outweighs the advantages because of:

- Fiduciary liability
- Administrative burdens and filing requirements, i.e., the requirements of the Department of Labor (DOL), the IRS, and the Pension Benefit Guaranty Corporation (PBGC)
- Administrative costs
- Responsibility for maintaining qualified status of plan
- Recordkeeping requirements

Depending upon the plan type chosen, contribution may be required each year. Contribution flexibility may be an issue.

Qualified Plan Trust Requirements

A trust forming part of a pension, profit-sharing, or stock bonus plan must meet the following tests to constitute a qualified trust under IRC Section 401(a).⁹ In general, the trust must:

- Be created or organized in the United States,¹⁰ and it must be maintained at all times as a domestic trust in the United States.¹¹
- Be established by an employer for the exclusive benefit of his employees or their beneficiaries.¹²
- Must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan.
- Specify the time and method of distribution that satisfy the minimum required distribution requirements of IRC Section 401(a)(9).
- Make it impossible at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.
- Be part of a plan that satisfies the minimum participation standards or which benefits such employees as qualify under a classification set

⁹ Treas. Reg. Section 1.401-1(a)(3).

¹⁰ As defined in IRC Section 7701(a)(9).

¹¹ DOL Reg. Section 2550.404b-1.

¹² IRC Section 401(a)(2)

up by the employer and found by the Commissioner of Internal Revenue not to be discriminatory in favor of certain specified classes of employees.¹³

- This requirement must be satisfied during at least one day in each quarter.¹⁴
- Be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees.¹⁵ In addition, all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan (benefits, rights, and features) must be made available in a nondiscriminatory manner. Benefits, rights, and features generally will meet this requirement only if each benefit, right and feature satisfies a *current availability* requirement and an *effective availability* requirement.¹⁶
- Be part of a plan which provides the nonforfeitable rights described in IRC Section 401(a)(7) relating to minimum vesting standards.
- Provide that forfeitures under a pension plan must not be applied to increase the benefits any employee would receive under such plan.¹⁷
- Provide that if the plan benefits any self-employed individual who is an owner-employee, that contributions by or on behalf of that owner-employee be made only with respect to the earned income of such owner-employee which is derived from the trade or business from which the plan is established.¹⁸

Reversions Sometimes Allowed

The plan must provide that it is impossible at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries for any part of the funds to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.¹⁹ Thus, no contributions or other amounts may be refunded to the employer. However, a plan (other than a SEP or SARSEP) may provide for the return of a contribution (and any earnings) under limited circumstances in which:

1. The contribution is conditioned on the initial qualification of the plan. For this rule to apply, an application for determination must be made to the IRS within the time prescribed by law for filing the employer's return for the taxable year in which such plan was adopted (or such later date as the Secretary of Treasury may prescribe) and the plan

¹³ IRC Section 410(b); Treas. Reg. Section 1.401-3.

¹⁴ IRC Section 401(a)(6).

¹⁵ IRC Section 401(a)(4), Treas. Reg. Sections 1.401-4; 1.401(a)(4).

¹⁶ See Treas. Regs. Sections 1.401(a)(4)-1(b)(3), 1.401(a)(4)-4(a).

¹⁷ IRC Section 1.401-7.

¹⁸ IRC Section 401(d).

¹⁹ IRC Section 401(a)(2).

receives an adverse determination from the IRS with respect to its qualification.²⁰

2. A plan may provide for the return to the employer of contributions made by reason of a good-faith mistake of fact and of contributions conditioned on deductibility if there has been a good-faith mistake in determining deductibility. Earnings attributable to any excess contribution based on a good-faith mistake may not be returned to the employer, but losses attributable to such contributions must reduce the amount returned.²¹
3. Employer contributions made to satisfy the quarterly contribution requirements applicable to most defined-benefit plans may revert to the employer if the contribution is conditioned on its deductibility, a requested private letter ruling disallows the deduction, and the contribution is returned to the employer within one year from the date of the disallowance of the deduction.²² A letter ruling request may not be needed if the employer contribution is less than \$25,000 and certain other requirements are met.²³
4. Upon the termination of a pension plan (but not a profit-sharing plan), all fixed and contingent liabilities to the employees and their beneficiaries have been satisfied, the employer may recover any surplus existing because of actuarial “error,” provided the plan specifically provide for such a reversion.²⁴

If a pension or annuity plan maintains a separate account that provides for the payment of medical benefits to retired employees, their spouses and their dependents, any amount remaining in such an account following the satisfaction of all liabilities to provide the benefits must be returned to the employer even though liabilities exist with respect to other portions of the plan.²⁵

Life Insurance Considerations

There is no law that requires a qualified plan to provide additional benefits upon the death of a participant beyond the participant’s accrued benefit.

The funding of plan benefits is generally accomplished by investing in securities, as opposed to or in addition to life insurance, guaranteed investment contracts, annuities, and real estate. If life insurance is purchased in a qualified plan, numerous tax and nontax issues need to be considered.

²⁰ ERISA Section 403(c)(2)(B); Rev. Rul. 91-4 (1991-1 CB 54).

²¹ ERISA Section 403(c)(2)(A), 403(c)(2)(C); Rev. Rul. 91-4 (1991-1 CB 54).

²² Rev. Proc. 90-49 (1990-2 CB 620).

²³ Rev. Proc. 90-49, Section 4 (1990-2 CB 620); see also Ltr. Ruls. 9021049 (Feb. 26, 1990), 8948056 (Sept. 8, 1989).

²⁴ Treas. Reg. Section 1.401-2(b); Rev. Ruls. 70-421 (1970-2 CB 85), 71-152 (1971-1 CB 126), 73-55 (1973-1 CB 196), 71-149 (1971-1 CB 118); ERISA Section 4044(d)(1).

²⁵ IRC Section 401(h)(5).

Although some individuals may be able to self-insure against a loss in earning power upon death, most individuals are unable to accumulate sufficient funds early in life to provide the dollars necessary to pay for such expenses as a mortgage, education for children left behind, and other debts and expenses. In a number of cases, an individual has the option of purchasing life insurance protection within a qualified plan. Whether life insurance should be purchased within a plan or outside of the plan is often a difficult question, but the simple answer is, "It depends."

Although estate taxes may be deferred until the death of the surviving spouse, they may not be deferred forever. Given the desirability of keeping life insurance proceeds out of the insured's estate, some professionals have developed the concept of the *subtrust* to own the life insurance policy.²⁶

Under IRC Section 79, an employer has the ability to provide up to \$50,000 of life insurance to employees and deduct the cost without the employee having to recognize the benefit as current income. Any coverage offered in excess of that amount would cause the employee to recognize a current economic benefit (PS-58/Table 2001 amounts).²⁷ On the other hand, the employer may offer the employee a death benefit through the qualified plan and deduct the cost of the insurance as a retirement plan contribution. (See Appendix C, "Employee Benefits Limits.")

Suitability

There are two basic conditions that should be met before life insurance can be considered appropriate or suitable inside a qualified plan: The participant has a need for life insurance; and the only available dollars for the premium are inside the qualified plan. On the other hand, if a participant has a need for life insurance, and the participant is contributing the maximum allowable to a qualified plan, and the participant has additional dollars to pay the premium for the insurance needed, then it is probably inappropriate to place the insurance inside the qualified plan. There are other instances in which purchasing insurance in a qualified plan is advantageous. Certain employees may be uninsurable because of poor health and are unable to buy an individual life insurance policy at any price. Some insurance companies will offer life insurance (limitations may apply) on a guaranteed-issue basis inside a pension plan so long as insurance is purchased for all the plan's participants. Thus, insurance may fulfill a need that may otherwise go unmet.

²⁶ See, Gary S. Lesser, *Life Insurance Answer Book for Qualified Plans and Estate Planning* (3rd Ed.). New York: Panel Publishers, 2002. Chapter 6.

²⁷ See Notice 2002-8, IRB 2002-04, page 398, regarding the tax treatment of split-dollar life insurance arrangements. The Notice replaced the outdated P.S. 58 table with a 2001 table. The new table more accurately reflects longer life expectancies and has the effect of shrinking the premium payment. Notice 2002-8 republished the 2001 PS 58 cost table that was issued in Notice 2001-10. The 2001 Table or the insurer's own published premium rates may be used instead of the rates in the 2001 Table, if such rates are available to all standard risks who apply for initial issue one-year term insurance. (See <http://www.irs.gov/pub/irs-irbs/irb02-04.pdf>.)

Note. The first few years of an insurance contract are the years in which the cash-value accumulation is extremely low. After those first years, the investment aspect of insurance improves dramatically. Thus, it could be argued that qualified plan dollars, which are pretax dollars (not counting the PS-58/Table 2001 costs), are extremely efficient dollars for the first few years of the policy. After those first few years, the participant could purchase the policy from the plan, for its comparatively low surrender value, and enjoy the better years of cash buildup outside the plan. Special conditions apply and provisions may be needed to distribute the policy.²⁸

New Fair-Market Value Valuation Rules

A new revenue procedure in conjunction with proposed regulations provides a temporary safe harbor for determining fair market value (FMV).²⁹ Fully insured plans under IRC Section 412(i) are subject to special rules (discussed elsewhere).³⁰ The regulations prevent taxpayers from using artificial devices to understate the value of the contract. Under the new rules, any life insurance contract transferred from an employer or a tax-qualified plan to an employee must be taxed at its full FMV.

Regulations did not define the terms *fair market value* and *entire cash value*.³¹ The proposed regulations would clarify that, where the regulations under IRC Section 402(a) refer to the *entire cash value* of a contract, such term should be interpreted as FMV.³² Thus, when a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the FMV of such contract is generally included in the distributee's income and not merely the entire cash value of the contracts. FMV for this purpose would be defined as the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed.

Under the interim rules, the cash value of a life insurance contract distributed from a qualified plan may be treated as that contract's FMV. The rules, effective February 13, 2004, permit the use of values that should be readily available from insurance companies because the cash value is an amount that, in the case of a flexible insurance contract, is generally reported in policyholder annual statements, and in the case of traditional insurance contracts, is fixed at issue and provided in the insurance contract.

A plan may treat the cash value as the contract's FMV at the time of distribution if that cash value is at least as large as the aggregate of (1) the pre-

²⁸ Prohibited Transaction Exemption 92-6, as issued by the Department of Labor, allows individuals, including owner-employees, to purchase a life insurance policy from a plan. The exemption expands the original Prohibited Transaction Exemption 77-8, but certain requirements must still be met, including that the policy would otherwise be surrendered if not purchased from the plan. Therefore, care must be taken that the plan document allow for the purchase of the policy by a participant under such circumstances. Specifically, the plan document might state, "Insurance policies will be sold to the participant after five years, or they will be surrendered at that time."

²⁹ Rev. Proc. 2004-16 (2004-10 IRB 559_1__); Prop. Reg. NPRM REG-126967-03 (2004-10 IRB 566)_ FR _)

³⁰ Rev. Ruls. 2004-20 (2004-10 IRB 546_1__); 2004-21 (2004-10 IRB 544_1__).

³¹ See, Treas. Reg. Sections 1.402(a)-1(a)(1)(iii), 1.402(a)-1(a)(2).

³² Prop. Treas. Reg. Section 1.402(a)-1(a)(1)(iii) and 1.402(a)-1(a)(2) (69 F.R. 7384, Feb. 17, 2004).

miums paid from the date of issue through the date of distribution, plus (2) any amounts credited to the policyholder with respect to those premiums, minus (3) reasonable mortality charges and reasonable charges, but only if they are actually charged on or before the distribution date and are expected to be paid.

If the contract is a variable contract, a plan may treat the case value as its FMV at the time of distribution provided that the cash value is at least as large as the aggregate of (1) the premiums paid from the date of issue through the date of distribution, plus (2) all adjustments made with respect to those premiums during the period that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges, but only if they are actually charged on or before the distribution date and are expected to be paid.

Interim Valuation Method

Pending the issuance of the proposed regulations in final form, Revenue Procedure 2004-16 prescribes an interim method of valuing insurance contracts. Under the *interim valuation method*, the cash value (without reduction for surrender charges) may be treated as the FMV of a contract, provided the cash value is no less than the amount computed using the following formula:

$$a + b - c$$

- a Equals the premiums paid from the date of issue through the date of determination.
- b Equals any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise). In the case of variable contracts, *by* equals all adjustments made with respect to the premiums paid from the date of issue through the date of determination (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts.
- c Equals reasonable mortality charges and reasonable other charges which are actually charged on or before the date of determination and are expected to be paid.

The *date of determination* is the date of a distribution, in the case of valuing a contract distributed from a qualified plan.

Arguments Against Life Insurance in Qualified Plans

The major arguments against offering life insurance in a qualified plan are as follows:

1. *Why put a shelter in a shelter?* Arguably, a life insurance contract is a tax shelter, inasmuch as the inside buildup of cash value is not currently taxed. A qualified plan by its very nature is also a shelter. Cer-

tainly, it would be unwise, for example, to put tax-free bonds earning 2 percent in a plan if taxable bonds with an equal investment risk paying 5 percent were available. In either case, the trust is not going to pay tax; so why take the lower return!

2. *May lower amount of funds available at retirement.* All life insurance contracts charge for providing a death benefit, and that charge will without question reduce the funds available to provide retirement benefits in a defined-contribution plan. In a defined-benefit plan, the cost of life insurance protection is in addition to the plan's normal cost of providing retirement benefits
3. *Administrative concerns.* The purchase of life insurance adds complications to plan administration. A life insurance policy is typically accounted for on a participant-directed basis. Often, it is difficult to obtain accurate data from an agent or insurer regarding cash value or FMV as of the valuation date, premiums paid during the plan year, and any dividends paid and how they were applied, as well as commission information for the Form 5500, Schedule A.
4. *Costs of protection taxable.* PS-58/Table 1 amounts reduce some of the advantages of purchasing insurance with pretax dollars.³³
5. *Difficulty in removing a policy.* Once an individual reaches retirement age, it becomes difficult to distribute life insurance policies. However, there are several methods to handle this issue. These methods include the purchasing of the policy from the plan and having the plan take a policy loan from the policy for the maximum cash value. Then the participant may purchase the policy for its new, current value, which is now zero (cash value minus the loan amount), and the loan proceeds may be distributed to the participant with the balance of the participant's account. Alternatively, the policy could be distributed to the participant and the participant would pay tax on the value of the policy. The participant could borrow from the policy to pay the taxes. The policy could be surrendered and the proceeds distributed with the balance of the participant's account.
6. Life insurance in a defined-benefit plan is not subject to as much criticism as it is in a defined-contribution plan. In the small-plan environment, where the size of the contribution (and therefore the deduction) is important, life insurance can often increase the amount of the deductible contribution. In other words, the investment risk is borne by the employer, not the employee, so there is no reduction in retirement benefits if an insurance policy underperforms other investments.

Prudence

It may not always be prudent to purchase life insurance in a qualified plan. For example, it would not be prudent to purchase whole life insurance with 50

³³ See IRS Notice 2002-8 (2002-1 CB 398); Rev. Rul. 66-110 (1966-1 CB 12).

percent of each year's contribution for employees of a plan that has high turnover: The result would obviously be extremely costly to participants with few years under the plan and the policy, because most of such a participant's account would have been absorbed in the acquisition costs of the insurance. On the other hand, a competitive insurance contract will provide a fair rate of return, in addition to the death benefit, for a participant who has many years in a plan (and under the policy). Variable life contracts are available today, which allow a policyholder to direct the investment of the policy's cash values among an assortment of investment categories similar to mutual funds. Although charges still apply for the pure cost of insurance and the insurance company's administrative costs, the remaining investment aspect of the policy can offer competitive returns. In recent years, there has been litigation in which plan trustees were questioned as to the prudence of using whole life contracts in a qualified plan.³⁴

Limits on Incidental Benefits

Nonpension benefits must be incidental to the main purpose of the plan—to provide benefits generally at retirement. Incidental benefits are generally benefits other than pure pension benefits offered under a qualified plan.³⁵

A pension plan (i.e., a money-purchase plan or a defined-benefit plan) may provide for payment of a pension as the result of a disability and for the “payment of incidental death benefits through insurance or otherwise.” A pension plan will not be qualified if it provides for the payment of benefits not customarily included in a pension plan, such as layoff benefits and benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in IRC Section 401(h)).³⁶

A profit-sharing plan may provide disability and incidental death benefits in the same manner as a pension plan. In addition, a profit-sharing plan may provide that amounts allocated to the account of a participant may be used to provide incidental life, accident, or health insurance for a participant's family.³⁷

After-Tax Contributions

The IRS has ruled that the incidental benefit restriction does not apply to life insurance or death benefits purchased with voluntary, nondeductible (i.e., after-tax) employee contributions.³⁸

³⁴ *Framingham Union Hosp* (D Mass, settled by consent Mar 14, 1990); *DOL v. Flexcon Profit Sharing Plan* (settled by consent Dec 10, 1993).

³⁵ See, Rev. Rul. 69-421, Part 2(n) (1969-2 CB 59).

³⁶ Treas. Reg. Section 1.401-1(b)(1)(i).

³⁷ Treas. Reg. Section 1.401-1(b)(1)(ii).

³⁸ Rev. Rul. 69-40 (1969-2 CB 58); Ltr. Rul. 9339024 (Jul. 7, 1993).

Note. After-tax contributions are subject to the IRC Section 401(m) non-discrimination test and the IRC Section 415 limits on annual additions. The 401(m) test generally limits the amount of after-tax and matching contributions for HCEs in proportion to contributions for NHCEs.³⁹

Rollovers and Transfers

The incidental benefit restriction generally applies to aggregate employer (i.e., pretax) contributions allocated to a participant. Therefore, unless amounts directly transferred or rolled over are after-tax amounts, they may be subject to the incidental benefit requirement. Note, however, that because the incidental benefit requirement is applied on the basis of aggregate contributions (rather than annual contributions), that is rarely an issue. It should be pointed out that the extent to which contributions that are made and amounts that are expended for life insurance protection need to be considered is unclear at this time if amounts have been transferred or rolled over from another plan. Also, records from the transferor plan may be difficult or impossible to obtain.

Incidental Defined-Contribution Plan Limit

The determination of when a death benefit under a defined-contribution plan is incidental has been largely a creation of revenue rulings. The basic rule is that ordinary life insurance purchased under a defined-contribution plan is incidental if the aggregate premiums for life insurance in the case of each participant are less than 50 percent (i.e., no more than 49 percent) of the aggregate contributions allocated to the participant at any particular time.⁴⁰ In the case of the purchase of other types of life insurance, however, the limit is 25 percent of contributions.⁴¹ The 25 percent is derived from the assumption that a 50-percent contribution used to pay premiums on ordinary life insurance is equivalent to a 25-percent pure insurance cost “since only approximately one-half of the premiums paid for such policies are for pure insurance protection.”⁴²

The 25-Percent Limit

Term, universal, and other life insurance policies not considered ordinary life policies are subject to the 25-percent limit. Ordinary life policies are defined as those that provide both nonincreasing premiums and nondecreasing death benefits.⁴³ The IRS has treated a variable life policy as an ordinary whole life policy where it provided a stipulated level amount of death benefit and scheduled level premiums.⁴⁴ In another ruling, the IRS reviewed a policy providing two alternative insurance plans, both with a level amount of coverage, but one consisting of term protection and the other of lifetime protection. It was possible to account for the premiums between the two. The IRS treated the lifetime

³⁹ IRC Section 401(m).

⁴⁰ Rev. Rul. 54-51 (1954-1 CB 147).

⁴¹ Rev. Rul. 66-143 (1966-1 CB 79).

⁴² Rev. Rul. 74-307 (1974-2 CB 126).

⁴³ Rev. Ruls. 66-143 (1966-1 CB 79), 70-611 (1970-2 CB 89), 76-353 (1976-2 CB 112).

⁴⁴ Ltr. Rul. 9014068 (Jan. 11, 1990).

protection as ordinary life and the term protection as other than ordinary life for purposes of the incidental benefit test.⁴⁵

Policy Dividends

Policy dividends applied to purchase paid-up additions must be taken into account in applying the incidental benefit limitations.⁴⁶ Thus, the dollar amount of such policy dividends so used must be aggregated with other premiums paid and the aggregate amount may not exceed the 25-percent/50-percent limits.

Any Time Rule

Life insurance is incidental if the aggregate of life insurance premiums for each participant does not exceed 25 percent or 50 percent, as applicable, of the aggregate contributions allocated to the credit of the participant at any particular time.⁴⁷

Incidental Defined-Benefit Plan Limits

Under a defined-benefit plan, life insurance will be considered incidental if the death benefit does not exceed 100 times the amount of the participant's anticipated monthly life annuity. Actuarially, the 100-to-1 rule is considered to be the equivalent of the 25-percent rule.⁴⁸ The monthly life annuity for purposes of the 100-to-1 rule is the pension that would have been payable to the participant at normal retirement date if he or she had continued in service to that date earning the compensation in effect at the time of death.⁴⁹

Post-Retirement Benefits

The incidental death benefit cannot extend beyond retirement. This means that the plan must require that upon retirement the life insurance policy must be either (1) converted to cash to provide retirement income or (2) distributed to the employee.⁵⁰ The same limitation has been applied to money-purchase pension plans.⁵¹ Death benefits under defined-benefit pension plans have also been held to be limited to preretirement.⁵²

Note. Each plan must apply the incidental benefit test separately.⁵³

⁴⁵ Ltr. Rul. 8725088 (Mar. 27, 1987).

⁴⁶ Ltr. Ruls. 9106022 (Nov. 9, 1990), 9215055 (Jan. 16, 1991).

⁴⁷ Rev. Rul. 66-143 (1966-1 CB 79).

⁴⁸ Rev. Ruls. 60-83 (1960-1 CB 157), 66-143 (1966-1 CB 79), 68-31 (1968-1 CB 151), 68-453 (1968-2 CB 163), 70-611 (1970-2 CB 89), 85-15 (1985-1 CB 132).

⁴⁹ Rev. Rul. 61-121 (1961-2 CB 65).

⁵⁰ Rev. Ruls. 54-51 (1954-1 CB 147), 57-213 (1957-1 CB 157), 60-84 (1960-1 CB 159).

⁵¹ Rev. Rul. 66-143 (1966-1 CB 79).

⁵² Rev. Rul. 85-15 (1985-1 CB 132); Field Service Advice 1999-633.

⁵³ Rev. Ruls. 70-28 (1970-1 CB 86), Rev. Rul. 71-25 (1971-1 CB 125).

Practice Pointer: The qualified joint and survivor annuity and qualified retirement survivor annuity rules generally will apply to a beneficiary designation.⁵⁴

Income Tax Consequences of Life Insurance

The cost of life insurance purchased with qualified plan funds is includible in an employee's gross income in the year the premium is paid. The amount included as income is the lesser of the cost determined under tables published by the IRS (referred to as the PS-58/Table 1 cost) (for 2001 only), or the published premium rates charged by the insurer for individual one-year term insurance available to standard risks.

Even though PS-58/Table 1 costs are taxable currently to an employee, they are not subject to the 10-percent excise tax on early distributions under IRC Section 72(t).⁵⁵ Neither do the 20-percent mandatory withholding requirement and voluntary withholding requirements apply to PS-58/Table 1 costs.⁵⁶

Reporting PS-58/Table 1 Costs

The instructions to Form 1099-R,⁵⁷ indicate that PS-58/ Table 2001 costs are reported on that form. Once the policyholder is no longer employed, the insurer should report the annual PS-58/Table 2001 costs on Form 1099-R.

Practice Pointer: A record of cumulative PS-58/Table 2001 costs should be maintained for any policy with a cash value for IRS tax reporting purposes. Because the taxed PS-58/Table 2001 costs constitute basis in such a policy, such basis information will be needed, for example, if the policy is distributed to the employee.

Death Before Retirement

Upon the death of a participant in a qualified plan before retirement, the difference between the face amount of the policy and its cash surrender value, if any, is exempt from income tax as death proceeds under IRC Section 101(a), if the insurance cost has been taxed to the employee as PS-58/Table 2001 costs.⁵⁸ The cash surrender value would be treated as taxable upon distribution, and that value would be reduced by the sum of the PS-58/Table 2001 costs already taxed to the employee.⁵⁹

⁵⁴ IRC §§ 401(a)(11), 417; ERISA § 205.

⁵⁵ Notice 89-25, Q&A 11 (1989-1 CB 662).

⁵⁶ Treas. Regs. Sections 1.402(c)-2, Q&A 4(f), 35.3405-1.

⁵⁷ Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, Etc.*

⁵⁸ Treas. Reg. Section 1.72-16(c)(4).

⁵⁹ Treas. Reg. Section 1.72-16(b).

Exhibit 4-1. Table 2001—Interim Table of One-Year Term Premiums for \$1,000 of Life Insurance Protection (2002–4 I.R.B.)

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	\$ 0.70	35	\$ 0.99	70	\$ 20.62
1	\$ 0.41	36	\$ 1.01	71	\$ 22.72
2	\$ 0.27	37	\$ 1.04	72	\$ 25.07
3	\$ 0.19	38	\$ 1.06	73	\$ 27.57
4	\$ 0.13	39	\$ 1.07	74	\$ 30.18
5	\$ 0.13	40	\$ 1.10	75	\$ 33.05
6	\$ 0.14	41	\$ 1.13	76	\$ 36.33
7	\$ 0.15	42	\$ 1.20	77	\$ 40.17
8	\$ 0.16	43	\$ 1.29	78	\$ 44.33
9	\$ 0.16	44	\$ 1.40	79	\$ 49.23
10	\$ 0.16	45	\$ 1.53	80	\$ 54.56
11	\$ 0.19	46	\$ 1.67	81	\$ 60.51
12	\$ 0.24	47	\$ 1.83	82	\$ 66.74
13	\$ 0.28	48	\$ 1.98	83	\$ 73.07
14	\$ 0.33	49	\$ 2.13	84	\$ 80.35
15	\$ 0.38	50	\$ 2.30	85	\$ 88.76
16	\$ 0.52	51	\$ 2.52	86	\$ 99.16
17	\$ 0.57	52	\$ 2.81	87	\$ 110.40
18	\$ 0.59	53	\$ 3.20	88	\$ 121.85
19	\$ 0.61	54	\$ 3.65	89	\$ 133.40
20	\$ 0.62	55	\$ 4.15	90	\$ 144.30
21	\$ 0.62	56	\$ 4.68	91	\$ 155.80
22	\$ 0.64	57	\$ 5.20	92	\$ 168.75
23	\$ 0.66	58	\$ 5.66	93	\$ 186.44
24	\$ 0.68	59	\$ 6.06	94	\$ 206.70
25	\$ 0.71	60	\$ 6.51	95	\$ 228.35
26	\$ 0.73	61	\$ 7.11	96	\$ 250.01
27	\$ 0.76	62	\$ 7.96	97	\$ 265.09
28	\$ 0.80	63	\$ 9.08	98	\$ 270.11
29	\$ 0.83	64	\$ 10.41	99	\$ 281.05
30	\$ 0.87	65	\$ 11.90		
31	\$ 0.90	66	\$ 13.51		
32	\$ 0.93	67	\$ 15.20		
33	\$ 0.96	68	\$ 16.92		
34	\$ 0.98	69	\$ 18.70		

Chapter 5

Compensation and Earned Income

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Compensation and Earned Income

How a retirement plan defines compensation can have a tremendous impact on the cost of providing promised benefits or on how fixed or discretionary contributions are allocated among eligible employees.

Compensation

In most cases, compensation is defined in a circular manner. For purposes of the nondiscrimination rules and any other provision of the Internal Revenue Code (IRC or the Code) that *specifically* refers to IRC Section 414(s), *compensation* means compensation as defined in IRC Section 415(c)(3), the all inclusive definition. IRC Section 414(s), however, permits an employer to either include or exclude elective contributions from this all inclusive definition for some, but not necessarily all purposes. For example, elective contributions made under the plan cannot reduce the compensation upon which a minimum IRC Section 416 top-heavy contribution is required. Specifically, IRC Section 416(i)(D) refers to IRC Section 414(q), that in turn refers to the basic all-inclusive definition found in IRC Section 415(c)(3); thus, the reduction to compensation allowed for elective contributions under IRC Section 414(s) never comes into play. Compensation may have a slightly different definition for other purposes of the Code. For a self-employed individual, *compensation* means the earned income of that individual (discussed below).¹

Compensation in excess of \$205,000 (the 2004 limit) is not taken into account.² The base compensation limit of \$200,000 (the 2002 limit) is indexed for inflation in increments of \$5,000.³ The 2005 limit is likely to remain at \$205,000. See Appendix C, “Employee Benefits Limits,” for indexed employee benefits limits and estimates for 2005.

Amounts that are received for personal services actually rendered in the course of employment with the employer are generally treated as compensa-

¹ See, IRC Sections 404(a)(12), 415(c)(3)(B), 408(k)(7)(B) regarding SEP.

² IRC Sections 401(a)(17), 414(s)(1); Notice 2003-73 (2003-45 IRB 1017).

³ IRC Section 401(a)(17).

tion to the extent that the amounts are includable in income. Generally, IRC Section 415(c)(3) compensation is the compensation of the participant from the employer for the year and generally includes but is not limited to:⁴

- Wages and salaries
- Fees for professional services
- Other amounts received (cash or noncash) for personal services actually rendered by an employee, including, but not limited to the following items:
 - Commissions and tips
 - Fringe benefits
 - Bonuses

Note. IRC Sections 415(c)(3) and 414(s) will automatically be satisfied by the use of wages as defined for income tax withholding purposes, or wages reportable in Box 1 of Form W-2 (which may include certain items that are not wages for withholding purposes).⁵

Compensation generally includes elective contributions contributed under any of the following plan types:⁶

- A qualified cash or deferred arrangement, i.e., an IRC Section 401(k) plan
- A tax sheltered annuity—i.e., an IRC Section 403(b) plan
- A savings incentive match plan for employees (SIMPLE) individual retirement account or annuity (IRA)
- A salary-reduction or elective simplified employee pension plan (SARSEP)
- A nonqualified deferred compensation plan (NQDC) under IRC Section 457(f)
- An IRC Section 125 cafeteria plan.

However, an employer may provide for the exclusion of elective contributions under the above plan types from the definition of compensation. It should be noted that the exclusion of elective contributions from the definition of compensation under a plan does not reduce the maximum deductible amount, but it is likely to reduce employer-provided contributions or benefits under the plan.

As a design issue, whether elective contributions should reduce compensation under a plan depends upon the number of owners and the level of their elective contributions, compared to the resulting compensation of rank-and-

⁴ IRC Section 415(c)(3); Treas. Reg. Section 1.415-2(d).

⁵ Treas. Regs. Sections 1.414(s)-1(c)(2), 1.415-2(d)(11).

⁶ IRC Section 414(s)(2); Treas. Reg. Section 1.414(s)-1(c)(4).

file employees. Once the plan's allocation or benefit formula applied, it is easier to determine which methodology best satisfies the employer's objectives.

Note. The exclusion of elective contributions from the plan's definition of compensation does not effect the maximum deductible amount (which is computed without reducing compensation by elective contributions under the plan); although it may reduce the level of employer-derived allocations or benefits. If the plan is integrated with Social Security, reducing compensation by elective contributions will reduce the excess compensation upon which integrated contributions are made and, as a design feature, is not generally advantageous if owners are more highly compensated than other participants.

Employers may demonstrate that a definition of compensation is nondiscriminatory using "snapshot" testing on a single day during the plan year, provided that day is representative of the employer's work force and the plan's coverage throughout the plan year.⁷

Nondiscriminatory Definition of Compensation

A definition of compensation other than IRC Section 415(c)(3) compensation can also satisfy IRC Section 414(s) if it meets the safe-harbor definition or meets one of the alternative definitions and a nondiscrimination test.⁸ The safe-harbor definition is IRC Section 415(c)(3) compensation, reduced by:⁹

1. Reimbursements or other expense allowances
2. Fringe benefits (cash and noncash)
3. Moving expenses
4. Deferred compensation
5. Welfare benefits

An alternative definition that defines compensation based on the rate of pay of each employee will also satisfy IRC Section 414(s) if the definition is nondiscriminatory and satisfies other requirements found in the regulations.¹⁰

Another alternative definition of compensation can satisfy IRC Section 414(s) if it is reasonable and does not, by design, favor highly compensated employees (HCEs) and it meets a nondiscriminatory requirement. The nondiscriminatory requirement is satisfied if the average percentage of total compensation included under the alternative definition for the employer's HCEs as a group does not exceed by more than a *de minimis* amount the average percentage of total compensation included under the alternative definition for

⁷ Rev. Proc. 93-42 (1993-2 CB 540).

⁸ IRC Section 414(s)(3).

⁹ Treas. Reg. Section 1.414(s)-1(c)(3).

¹⁰ Treas. Reg. Section 1.414(s)-1(e).

the employer's other employees as a group.¹¹ Self-employed individuals are subject to special rules for purposes of using an alternative definition.¹²

As an alternative to the IRC Section 415 definition of compensation, a plan, including a simplified employee pension plan (SEP) or a SARSEP, may define compensation using one of the following three definitions used for wage reporting purposes and automatically be deemed to satisfy IRC Section 415(c)(3). The three alternatives do not apply to self-employed individuals treated as employees within the meaning of IRC Section 401(c)(1).

W-2 Earnings

This alternative includes amounts required to be reported under IRC Sections 6041, 6051, and 6052 (wages, tips, and other compensation box on Form W-2, Wage and Tax Statement). That is, compensation is defined as wages within the meaning of IRC Section 3401(a) and all other payments of compensation to an employee by his or her employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under IRC Sections 6041(d), 6051(a)(3), and 6052.¹³ This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for an employee's moving expenses, but only to the extent that at the time of the payment it is reasonable to believe that the employee may deduct such amounts under IRC Section 219. Compensation is to be determined without regard to any rules under IRC Section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (e.g., the exception for agricultural labor in IRC Section 3401(a)(2)).

IRC Section 3401(a) Wages

Under this alternative, *compensation* is defined as wages within the meaning of IRC Section 3401(a) (which generally includes, for purposes of income tax withholding at the source, all remuneration for services performed as an employee other than fees paid to a public official) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (e.g., the exception for agricultural labor in IRC Section 3401(a)(2)).

IRC Section 415 (the Safe-Harbor Section) Compensation

The IRC Section 415 safe-harbor definition of compensation is generally a streamlined version of the full IRC Section 415 definition. It is intended to simplify the full definition by including an employee's basic wages without the required adjustments of the full IRC Section 415 definition. Under this alternative, compensation is defined as wages, salaries, fees for professional services, and other amounts received (without regard to whether an amount is

¹¹ Treas. Reg. Section 1.414(s)-1(d).

¹² Treas. Reg. Section 1.414(s)-1(d)(3)(iii)(B), 1.414(s)-1(g).

¹³ Treas. Reg. Sections 1.6041-1(a), 1.6041-2(a)(1), 1.6052-1, 1.6052-2; see, too, Treas. Reg. Section 31.6051-1(a)(1)(i)(C).

paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan, to the extent that the amounts are includable in gross income. Such amounts include but are not limited to commissions paid to salespersons, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in Treasury Regulations Section 1.62-2(c)(3)) and may exclude the previously mentioned items that IRC Section 415 compensation does not include.

Earned Income

The earned income of a self-employed individual who is an employee within the meaning of IRC Section 401(c)(1) is treated as his or her compensation. The earned income of a partner in an organization established as a limited liability partnership (LLP) or limited liability company (LLC) is also treated as his or her compensation.¹⁴

Note. Compensation includes the net income from operating oil, gas, or mineral interests or the net earnings of a self-employed writer, inventor, or artist. Nevertheless, a royalty paid for the right to use a copyright or patent or an oil, gas, or mineral property is taxable, although it is not generally treated as earned income.

Dividend income (S corporation or otherwise) is a return on invested capital, not a return on labor (wages). It does not count for plan establishment or plan contribution purposes. Suppose, for example, a taxpayer improperly, in the view of the IRS, either inflates his or her S corporation dividend and correspondingly reduces his or her earned income to; for example, reducing Social Security or Medicare taxes or deflating his or her S corporation dividend and correspondingly increasing his or her earned income in order to get a higher pension contribution. Under such circumstances, a challenge from the IRS is possible, though not likely, because the IRS maintains that it has the right to recharacterize the split between the two to reflect what it determines is the “economic reality.” If the filed return reflects economic reality, dividends do not count toward compensation for plan purposes.¹⁵ In *Grey’s Public Accountant*,¹⁶ the owner of a Sub S treated himself as an independent contractor and reported payments for services on Form 1099. The Tax Court held that the owner was an employee and that the wages were subject to employment taxes Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA), i.e., not Self-Employment Contributions Act (SECA). Can you be an independent contractor for and the sole shareholder of your S corporation?

¹⁴ Prop. Treas. Reg. Section 1.1402(a)-18.

¹⁵ *Durando v. United States*, 70 F3d 589 (9th Cir. 1995).

¹⁶ *Grey’s Public Accountant, PC v. Commissioner* (119 TC No. 5).

Maybe, depending upon the facts. In *Veterinary Surgical Consultants, P.C.*,¹⁷ the facts worked against the taxpayer. The corporation did veterinary consulting and had only one employee who was a veterinarian, the president and sole shareholder, and his services were essential to the business. He claimed to be an independent contractor. The Tax Court held that he was an employee. The Court also held, as in *Grey*, that the corporation could not avail itself of the benefits of Section 530 of the Revenue Act of 1978 (which provides for reduced penalties) because the corporation did not have a reasonable basis for treating the worker as an independent contractor. The taxpayer was the only employee and his services were essential to the operation of the business. Arguably, an individual might be considered an independent contractor if their services are not essential to the business and they have another business. For example, Horace is a 25-percent owner in a building contractor, but also does business as a lawyer. Horace does legal work for the contractor and bills them through his law firm.¹⁸

Keep in mind that amounts earned by partners and shareholder-partners of an LLC are not wages subject to FICA, FUTA, or federal income tax withholding.¹⁹

Under IRC Section 401(c)(2), earned income for a self-employed person (including a partner in a partnership) refers to net earnings from self-employment in a trade or business in which the personal services of that individual are a material income-producing factor.²⁰ After several adjustments, up to \$205,000 of earned income may be considered for plan allocation and employer deduction purposes.²¹ The adjustments not only affect one another but also may be affected by other factors. Under IRC Section 401(c)(2), net earnings from self-employment must be reduced by all contributions made by or on behalf of the owner and by the deduction for half of the self-employment tax under IRC Section 164(f). It should be noted that the owner's share of the allowable contribution expense for nonowner employees must be subtracted from business income to arrive at the amount of net earnings from self-employment. In the case of a partnership or a limited liability company, earned income may include guaranteed payments to members.²²

Note. For taxable years beginning after 2001, elective contributions are added back for the purpose of calculating the employer's maximum deduction (but not generally for the purpose of computing the 25-percent participant exclusion limit in a SEP). Elective contributions may be added back when allocating an employer's nonelective contributions among employees.

¹⁷ *Veterinary Surgical Consultants, P.C.* (117 TC No 14, Oct 15, 2001).

¹⁸ See also *Yeagle Drywall*, TC Memo 2001-284, the taxpayer's services were essential and a 99-percent stockholder was treated as an employee and not an independent contractor.

¹⁹ IRS Legal Memo 200117003 (Apr 27, 2001).

²⁰ IRC Section 1402(a).

²¹ IRC Sections 401(a)(17), 404(l).

²² Ltr. Ruls. 9525058 (Mar. 28, 1985), 9452024 (Sept 29, 1994), 9432018 (May 16, 1994); see Form 1065, Schedule K-1, line 22.

IRC Section 1402 defines the term *self-employment income* as net earnings from self-employment derived by an individual during any taxable year. IRC Section 1402(a) provides that the term *net earnings from self-employment* includes an individual's distributive share (whether or not distributed) of income or loss described in IRC Section 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member. IRC Section 1402(a)(13) provides that the distributive share of any item of income or loss of a limited partner is not included under the definition of net earnings from self-employment unless the distributive share is a guaranteed payment to that partner for services actually rendered to or on behalf of the partnership to the extent that such payment is established to be in the nature of remuneration for those services. In the view of the IRS, it is generally not essential that an individual currently be engaged in the day-to-day conduct of a trade or business in order to be carrying on a trade or business. A taxpayer can still be engaged in a trade or business even if there is a temporary hiatus in the conduct of the activities of that trade or business.²³

Recent cases have adopted more narrow interpretations of what constitutes self-employment income for self-employment tax purposes.²⁴ Whether a payment is derived from a trade or business carried on by an individual for purposes of IRC Section 1402 depends on whether, under all the facts and circumstances, a nexus exists between the payment and the carrying on of the trade or business. The Tax Court articulated this nexus requirement in *Newberry v. Commissioner*,²⁵ observing that, under IRC Section 1402, there must be a nexus between the income received and a trade or business that is or was actually carried on. Put another way, the construction of the statute can be gleaned by reading the relevant language all in one breath: The income must be derived from a trade or business carried on. Thus, the trade or business must be "carried on" by the individual, either personally or through agents or employees, in order for the income to be included in the individual's "net earnings from self-employment."²⁶

Generally, the required nexus exists if it is clear that a payment would not have been made but for an individual's conduct of a trade or business.²⁷ Although the IRS agreed with the Tax Court in *Newberry* that a nexus must exist, it did not agree with the court's conclusion in that case that such a nexus cannot exist if an individual is not currently engaged in the day-to-day conduct of a trade or business. Therefore, the IRS declared that it will not follow the decision in *Newberry*.²⁸

²³ *Newberry v. Commissioner*, 76 TC 441, 444 (1981); see also *Reisinger v. Commissioner*, 71 TC 568, 572 (1979); *Haft v. Commissioner*, 40 TC 2, 6 (1963); see also Rev. Rul. 75-120 (1975-1 CB 55), job search costs may be deductible trade or business expenses even if taxpayer is temporarily unemployed.

²⁴ IRC Section 1402(a)-(b).

²⁵ 76 TC 441, 444 (1981).

²⁶ S Rept 1669, 81st Cong, 2d Sess (1950) (1950-2 CB 302, 354)

²⁷ *Newberry v. Commissioner* (76 TC 441, 444 (1981)).

²⁸ Rev. Rul. 91-19 (1991-1 CB 186).

Example. Jeb, a farmer, suffered an \$8,000 crop loss resulting from a drought. Jeb received an \$8,000 loan from the Farmers Home Administration (FHA), of which \$5,000 of the principal was immediately canceled. The amount of the canceled portion of the loan represents a replacement of a portion of the farmer's lost profits, and must be taken into account in computing Jeb's net earnings from self-employment.²⁹

Example. Fred was performing services as an independent contractor for a government agency. His contract was terminated after four years due to an act of war. He promptly accepted a position as an employee for a corporation after his contract was terminated. Eighteen months later, Fred was given an unexpected severance payment of \$1,000 to \$2,500 for each year of prior service. Although the IRS would likely view this as earned income because there was a previous nexus, the courts may be more lenient because Fred's severance payment was not derived from a trade or business carried on. The "tax on self-employment income" imposed by IRC Section 1401, unlike the employment taxes imposed on wages in subtitle C, is technically an income tax because IRC Section 1401 is part of subtitle A of the Code.

Note. A partner's compensation is deemed currently available on the last day of the partnership's taxable year. Accordingly, an individual partner may not make a cash or deferred election with respect to compensation for a partnership taxable year after the last day of that year.³⁰

Periodic advances made by partners throughout the year, pursuant to an election of the partner, are *elective contributions*, assuming the plan otherwise satisfies the applicable requirements of the Code.³¹

The definition of compensation for a self-employed person as determined in the plan document is extremely important in applying plan limitations and preventing discrimination. A plan may provide for employer contributions to be allocated to employees, including self-employed individuals, based on their compensation, including or excluding their elective contributions.

An erroneous calculation of earned income could result in the violation of various nondiscrimination rules or could cause the IRC Section 415 dollar or percentage limits on allowable contributions and benefits to be exceeded. A miscalculation could also result in operational discrimination in favor of HCEs and could jeopardize the tax-sanctioned status of the plan.

Even practitioners with a thorough understanding of how plan limits are applied and how earned income is figured will find the process of designing plans, calculating contributions, and applying limits a complex, nearly impossible task. It is difficult to design a plan around an owner because the owner's compensation fluctuates as the contribution amount is changed. Circular and interdependent calculations are required to solve for a particular result. Ab-

²⁹ Rev. Rul. 76-500 (1976-2 CB 254); see also Rev. Rul. 60-32 (1960-1 CB 23); Notice 87-26 (1987-1 CB 470).

³⁰ See Treas. Reg. Section 1.401(k)-1(a)(6)(ii)(B).

³¹ Ltr. Rul. 200247052 (Aug. 28, 2002); see also Treas. Reg. Sections 1.401(k)-1(a)(3)(i), 1.401(k)-1(g)(3).

sent a legislative change, the practitioner must use caution. Spreadsheet software and programs offer a welcome solution for practitioners who need to design plans for owners of unincorporated businesses with common-law employees.

Self-Employment Losses

A self-employment loss from a separate unincorporated business that is unrelated to the employer adopting the plan but is owned in part by the same individual does not directly offset the earned income of the employer adopting the plan. There is no such thing as negative compensation. Nevertheless, the loss will affect the calculation of the individual's self-employment tax, and the amount of that tax will have an effect on the calculation of earned income that can be considered for the plan.

Practice Pointer: Frequently, partners have different tax preparers. Information from the uncompleted federal income tax returns of some partners may be needed to compute the contributions to be made under the plan and to complete the federal income tax returns of the partnership, and in turn the individual federal income tax returns of the individual partners can be completed. Return preparation is much easier when all partners and the partnership have the same tax preparer; privacy issues are also minimized.

Determining Earned Income: Where to Start

Partners

There is no line number or amount on any tax return, worksheet, or schedule that can be used as the correct starting point for calculating a partner's pre-plan earned income or self-employment tax. It does seem prudent, however, to start with line 15a of Schedule K-1 to Form 1065, U.S. Return of Partnership Income. (Up to four adjustments are possible when using the amount from that line.) The amount on that line is initially determined using a worksheet (see below) provided in the instructions to Form 1065, and then is allocated to the individual partners. Thus, line 15a on Schedule K-1 of Form 1065 cannot always be determined simply by adding line 1 (ordinary income) and line 5 (guaranteed payments to partner) of Schedule K-1.³²

Practice Pointer: If an individual's tax return is properly completed, line 15a on Schedule K-1 of Form 1065 is a suitable starting point for calculating earned income.

³² See Form 1065 instructions and worksheet for Schedules K and K-1, lines 15a.

Note. Similar rules apply to calculate self-employment income to electing large partnerships using Form 1065-B, Return of Income for Electing Large Partnership, except that line 14a is the relevant starting point for Schedule K and box 9 for Schedule K-1 (of Form 1065-B). The Form 1065-B worksheet is similar, but not identical to the Form 1065 worksheet (see Form 1065-B, Instructions, page 27 for 2002).

If there is an ordinary gain or loss on the sale of business property (from Form 4797 Part II, Sales of Business Property), the worksheet contained in the instructions to Form 1065 provides for included losses to be added back and included gains to be subtracted out before allocation to each partner. That adjustment (sometimes referred to as an “off-sheet” adjustment) appears in the instructions to Form 1065 but not on Schedule K or K-1:

Its absence from Form 1065 (and its relevance to determining the correct amount on line 15a) explains why line 15a of Schedule K-1 to Form 1065 cannot always be determined simply by adding line 1 (ordinary income) and line 5 (guaranteed payments to partner) of Schedule K-1.³³

See the “Worksheet for Calculating Ultra Net Earned Income,” below.

In addition to an adjustment for ordinary gains or losses on the sale of business property reflected on Schedule K-1, the instructions for Form 1065, Schedule K-1, line 15a, provide for the amount on that line to be entered on Schedule SE to Form 1040 after three more off-sheet reductions are made (in addition to that for ordinary gains or losses on the sale of business property):

1. *IRC Section 179 expense deduction claimed.* Schedule K-1 shows only the IRC Section 179 deduction being passed through to the partner (line 9). The deduction actually claimed, however, is on Form 4562, Depreciation and Amortization, line 12. For example, if an individual is a partner in several partnerships, not all of the IRC Section 179 expenses may be deductible.
2. *Claimed unreimbursed partnership expenses.* Not all legitimate partnership expenses are run through the business. Such expenses, although not technically nonpassive losses, are reported on Form 1040, Schedule E, Supplemental Income and Loss, Part II, line 27(i). Unreimbursed partnership expenses that partners are required to pay under the terms of the partnership agreement are deductible.³⁴
3. *Depletion on oil and gas properties claimed.*³⁵

³³ L.C. Starr, ASPA, Eastern Regional Seminar, “Sole Proprietorship and Partnership Compensation and Deduction Issues” (audiotape) (1995).

³⁴ See Form 1040, Schedule E, Instructions to Parts II and III, Partnerships.

³⁵ See Form 1065, Instructions, Adjustments, and Tax Preference Items.

Note. If the net earnings from self-employment from line 15a of a partner's Schedule K-1 are reduced, the instructions for Schedule SE require an explanation to be attached.

Sole Proprietors

The calculation of a sole proprietor's earned income starts with line 31 ("bottom-line Schedule C" income) of Schedule C, Profit or Loss From Business (Sole Proprietorship), to Form 1040, although the amount that appears there will need to be adjusted slightly for the owner's contribution and one-half of the self-employment tax deduction. That line is also reported on Form 1040, Schedule SE.

Following is a worksheet for calculating *ultra net* (i.e., after all adjustments) earned income under IRC Section 401(c)(2) for purposes of allocating contributions and calculating the employer's deduction and the amount of contributions that may be excluded from the employee's gross income.

Worksheet for Calculating Ultra Net Earned Income

1. Total earned income before any plan contributions (for 2004, Schedule K-1, line 15a, plus partner's share of nonowner employee contributions shown on Form 1065, line 18).....	\$_____
2. Less any unreimbursed partnership expense claimed (data from the accountant or Form 1040, Schedule E, Part II, column (i)).....	-\$_____
3. Less IRC Section 179 expense deduction claimed (see Schedule K-1, line 9, and confirm on Form 4562, line 12)....	-\$_____
4. Less depletion claimed on oil and gas properties (see Schedule SE, Instructions, Partnership Income or Loss).....	-\$_____
5. Preplan compensation (items 1-4):	=\$_____
<i>Sole Proprietorships, start here.</i>	
6. Less owner's share of common-law employee allocations (Form 1065, line 18, multiplied by partner's share percentage, or line 19 from Schedule C if self-employed)	-\$_____
7. Net amount for determining Social Security in lieu of deduction under IRC Section 1402(a)(12) and Social Security tax (Items 5 and 6)	=\$_____
8. Less half of Social Security tax deduction (if individual also has W-2 income, complete long Schedule SE to reflect the proper SE tax and in lieu of deduction).....	-\$_____
9. Less elective and nonelective contributions for owner	\$_____

Worksheet for Calculating Ultra Net Earned Income *(continued)*

10. Earned income for SEP exclusion purposes (Items 7–9; up to \$205,000)	= \$ _____
11. Plus elective contributions of owner*	+ \$ _____
12. Earned income for deduction purposes (not to exceed \$205,000)	= \$ _____
13. Earned income for the allocation of plan contributions (Items 10 and 11 up to \$205,000)*	= \$ _____

* Not all plans provide for elective contributions to be included in the definition of earned income for the purpose of allocating employer contributions. For contribution allocation purposes after 1997, compensation generally may include elective contributions. For example, under a prototype SEP document, but not a model SEP document, elective contributions are treated as compensation for contribution allocation purposes.

Interests in Multiple Entities

If a self-employed individual has an interest in more than one entity, more than one entity may have to be considered in designing the plan, testing for various limits, and avoiding discrimination initially or in operation. The employers may be related or unrelated, or they may be considered related for some purposes but not all. For instance, if a sole proprietor has an interest in multiple related or controlled employers, in most cases, those employers will all adopt the plan. What if one of the entities was unrelated and did not adopt the plan? Would the deduction for half of the owner's self-employment tax have to be prorated? Possibly, says one commentator.³⁶

When the ultra net earned income is less than the \$205,000 maximum for 2004, the proration of the self-employment tax deduction among multiple entities (to increase the amount of earned income that is considered for plan purposes) would seem preferable to allocating all of the earned income to the entity that adopted the plan.³⁷ At the same time, it should be noted that allocating all of the self-employment tax to a nonadopting entity (to maximize the amount of earned income that is considered for plan purposes) might be considered aggressive.

³⁶ Lawrence Starr, ASPA, Eastern Regional Seminar, "Sole Proprietorship and Partnership Compensation and Deduction Issues" (audiotape) (1995).

³⁷ See Ann 94-101, Section 684, Exh I (1994-35 IRB 53).

Chapter 6

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General Plan Design

There are several qualification requirements unique to defined-contribution plans (i.e., money-purchase pension plans or profit-sharing plans or stock bonus plans). This chapter discusses these requirements.

Defined-Contribution Plan Requirements

A defined-contribution plan:

- Must require separate accounting for each employee's accrued benefit.¹
- May not exclude employees who are beyond a specified age.²
- Must contain the limitation on annual additions that can be allocated to a participant's account or accounts under an employer's defined-contribution plan or plans. In general, the amount that may be allocated to a participant's account in a defined-contribution plan may not exceed the lesser of (a) 100 percent of a participant's compensation or (b) \$41,000 (the 2002 limits), plus catch-up contributions if permitted under the plan.³
- Must provide for the allocation of contributions and trust earnings to participants in accordance with a definite formula.⁴
- Must provide for distributions in accordance with an amount stated or ascertainable and credited to the participant's account(s).⁵
- Must value the investments held under the trust, at least once a year, on a specified inventory date, in accordance with a method consis-

¹ IRC Section 411(b)(2).

² IRC Section 410(a)(3).

³ IRC Section 415(c)(1).

⁴ Treas. Reg. Section 1.401-1(a)(2)(ii), 1.401-1(b)(1)(i).

⁵ Rev. Rul. 70-125 (1970-1 C.B. 87).

tently followed and uniformly applied.⁶ This requirement may, however, be satisfied in a plan in which contributions are invested solely in insurance contracts or in mutual fund shares even if there is no provision in the plan for periodic valuation of assets.⁷

- Must designate whether it is a money-purchase pension plan or a profit-sharing plan.⁸

Target-benefit plans, in which the actual pension is based on the amount in the participant's account, are treated as defined-contribution plans. Hybrid plans which are part target and part defined benefit are be treated as defined contribution to the extent that benefits are based on the individual account.⁹

Allocation of Expenses

A defined-contribution plan is permitted to charge the accounts of former employees that do not take an available distribution for their share of the plan's administrative expenses, even though the employer pays the expenses associated with the accounts of the active employees.¹⁰

In a 2004 revenue ruling,¹¹ the Internal Revenue Service (IRS) held that a defined-contribution plan may charge a pro-rata share of reasonable administrative fees to a terminated vested participant who does not take an available distribution. This ruling clears up the uncertainty caused by the Department of Labor's (DOL's) approval of such action last year in Field Assistance Bulletin 2003-3 without the IRS issuing any guidance supporting the DOL's position. IRS decided that charging administrative fees to terminated vested employees while not assessing such fees on active employees does not impose a significant detriment on the exercise of participants' rights, and, therefore, was not a violation of the vesting rules.

The IRS reasoned that if the terminated vested employee rolled over a distribution into an individual retirement account or annuity (IRA), he or she would probably incur administrative expenses from the IRA trustee or custodian. Thus, the IRS concluded that charging employees for leaving their accounts in the plan does not impose any significant additional cost.

Caution: *The ruling provides no guidance on the allocation of expenses in the case in which a participant does not have the option to receive a lump sum.*

The IRS ruling specifically approves of an allocation that is based on multiplying the ratio of the individual participant's account balance to all account balances by the appropriate administrative charges. The ruling also states

⁶ Rev. Rul. 80-155 (1980-1 CB 84).

⁷ Rev. Ruls. 73-435 (1973-2 CB 126), 73-554 (1973-2 CB 130).

⁸ IRC Section 401(a)(27)(B); Rev. Rul. 94-76 (1994-2 CB 46).

⁹ Announcement 95-33 (1995-19 IRB. 14).

¹⁰ Rev. Rul. 2004-10 (2004-10 IRB 484). It is not treated as a "significant detriment," see Treas. Reg. Section 1.411(a)-11(c)(2)(i).

¹¹ Rev. Rul. 2004-10 (2004-10 IRB 484).

that other allocation methods that would directly charge the administrative costs associated with the terminated participant's vested accounts would be acceptable, but it did not endorse any particular method. In addition, and in accordance with the DOL's guidance, the expenses charged must be plan administrative expenses and not expenses associated with redesigning the plan.

The IRS also cautioned that the policy of charging terminated vested employees is subject to the general nondiscrimination rules that require similar treatment for both highly compensated employees (HCEs) and nonhighly compensated employees (NHCEs).

Whatever policy is adopted by the plan's sponsor, the plan document, summary plan description (SPD), and other communication materials should accurately reflect the policy. Depending on the number of terminated vested employees that still maintain accounts within the plan, some savings could result for the employer by charging them reasonable administrative fees, even though the employer picks up the expenses associated with active employees. If a decision is made to charge such administrative fees, other communication materials given to participants should be revised accordingly.

Plan Types

There are a number of plan types, including profit-sharing plans, stock bonus plans, savings and thrift plans, 401(k) plans, employee stock ownership plans (ESOPs), pension plans, target-benefit plans, 412(i) plans, and cash-balance plans. Each is discussed in the following sections.

Profit-Sharing Plans

As its name implies, a profit-sharing plan is a plan for sharing employer profits with the employees. A profit-sharing plan need not provide a definite, predetermined formula for determining the amount of profits to be shared. However, there must be recurring and substantial contributions, and contributions must not be made at such times and in such amounts that the plan in operation discriminates in favor of HCEs.¹²

A profit-sharing plan must provide a definite, predetermined formula for allocating the contributions among the participants, and for distributing the accumulated funds to the employees after a fixed number of years (at least two), the attainment of a stated age, or upon prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. The allocation formula is generally related to compensation, although age, service, and other factors may be given consideration. A profit-sharing plan may use funds in an employee's account to provide incidental life or health insurance for the employee and/or the employee's family.¹³ A profit-sharing plan may even purchase incidental joint and survivor life insurance

¹² Treas. Reg. Section 1.401-1(b)(1)(ii).

¹³ Treas. Reg. Section 1.401-1(b)(1)(ii); Rev. Ruls. 68-24 (1968-1 CB 150), 69-414 (1969-2 CB 59), 71-295 (1971-2 CB 184).

on the life of a participant and a member of the participant's family, and the plan may provide that the trustee is to distribute, i.e., to sell for its fair-market value (FMV), the policy to the participant upon the death of nonparticipant beneficiary while the participant is employed.¹⁴ A proposed amendment to the exemption would allow a sale of a policy by a plan to a personal or private trust for the participant or a relative.¹⁵

Example. A profit-sharing plan provides that funds accumulated for a two-year period will be distributed to participants upon the attainment of age 40. The provision is allowable in a profit-sharing plan. Unless an exception applies, distributions prior to age 59½ may be subject to a 10-percent premature distribution tax penalty.

A tax-exempt nonprofit charitable organization may maintain a profit-sharing plan and if not a state or local government employer, the plan may include a cash or deferred arrangement, such as a 401(k) plan.¹⁶

Stock Bonus Plans

A stock bonus plan is similar to and provides benefits similar to those of a profit-sharing plan, except that benefits are distributable in stock of the employer. The employer contributions are not necessarily dependent on profits. Generally, the IRS has taken the position that distributions must be in the form of employer stock, except for the value of a fractional share, and at least one court agrees.¹⁷

However, a stock bonus plan may provide for the payment of benefits in cash if certain conditions are met. A stock bonus plan (or an ESOP) generally is required to give participants the right to demand benefits in the form of employer securities, and if employer securities are not readily tradable on an established market, the participant generally must have the right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula (called a *put option*).¹⁸ The put option must be available for at least 60 days following distribution of the stock and, if not exercised within that time, for another 60-day (minimum) period in the following year. The plan may repurchase the stock instead of the employer, but may not be required to do so. Banks prohibited by law from redeeming or purchasing their own shares are excused from the requirement that they give participants a put option.¹⁹

¹⁴ See ERISA Section 3(15); IRC § 4975(e)(6); PTCE 92-6 (57 FR 5189); DOL Op. Ltr. 98-07A.

¹⁵ See 67 FR 31835, which would be retroactive to February 12, 1992, if adopted.

¹⁶ IRC Section 401(k)(4)(B); GCM 38283 (2-15-80).

¹⁷ Rev. Rul. 71-256 (1971-1 CB 118); *Miller v. Comm.*, 76 TC 433 (1981).

¹⁸ IRC Section 409(h), 409(h)(7), 409(h)(2)(B).

¹⁹ IRC Section 409(h)(3) and (4).

A stock bonus plan must also pass through certain voting rights to participants or beneficiaries. If the employer's securities are *registration type*,²⁰ each participant (or beneficiary if applicable) must be entitled to direct the plan as to how securities acquired after 1979 and allocated to the participant are to be voted.²¹ Special rules apply to securities that are not registration type.²²

Savings and Thrift Plans

Savings and thrift plans are defined-contribution plans in which employee contributions generally make up a relatively large part of total contributions. The IRC makes no specific provision for these plans, but they may be tax qualified if they meet the requirements for a pension, profit-sharing, or stock bonus plan. A savings or thrift plan may qualify as a pension plan (e.g., a money-purchase plan) unless there are preretirement privileges to withdraw benefits. Frequently, they are established as profit-sharing plans by providing for employer contributions out of current or accumulated profits.

401(k) Plans

A 401(k) plan generally is a profit-sharing plan or stock bonus plan which provides for contributions to be made pursuant to a cash or deferred arrangement (CODA), under which individual participants elect to take amounts in cash or to have the amounts deferred under the plan. Amounts deferred under this election, including catch-up contributions, are excluded from a participant's gross income for the year of the deferral and treated as employer contributions to the plan for various purposes including the deduction rules.²³

A 401(k) plan may provide that all employer contributions are made pursuant to an employee's election to defer or may provide that the cash or deferred arrangement is in addition to employer derived contributions. Typically, the employer contributions are in the form of a percentage match for each dollar deferred by an employee. In either case, the top-heavy rules generally apply.

Employers without employees may find a 401(k) plan extremely attractive. Twenty-five percent of preplan compensation, plus elective contributions, may be contributed and deducted up to \$41,000 (for 2004, \$44,000 with catch-up contributions).

Example. Yetta Bow Corporation maintains a qualified 401(k) profit-sharing plan and makes the maximum contribution. Yetta, age 40, earned \$100,000 and elected to defer \$13,000. She is the only participant, so the ADP discrimination tests do not apply. The corporation may deduct \$38,000

²⁰ That is, if they must be registered under Section 12 of the Securities and Exchange Act of 1934 or would be required to be registered except for an exemption in that Act; See the Securities and Exchange Act of 1934, Section 12(g)(2)(H)).

²¹ IRC Sections 401(a)(28), 4975(e)(7), 409(e)(2).

²² IRC Sections 401(a)(22), 409(e)(3), 409(e)(5).

²³ Treas. Reg. Section 1.401(k)-1(a)(4)(ii), 1.401(k)-1(a)(4)(iii).

$((\$100,000 \times .25) + \$13,000)$. If Yetta were age 50 or older, her maximum total deductible contribution would be \$41,000 ($\$25,000 + \$13,000 + \$3,000$).

Example. Same facts as in the preceding example, except Yetta earns \$112,000. \$41,000 may be contributed (meaning, $[\$112,000 \times .25] + \$13,000$ may be contributed and deducted by Yetta Bow). If Yetta were over age 49, she could receive a total deductible contribution of \$44,000 ($\$28,000 + \$13,000 + \$3,000$).

Employee Stock Ownership Plan

An ESOP is a defined-contribution plan that must be a qualified stock bonus plan or a qualified stock bonus plan and a qualified money-purchase pension plan.²⁴

An ESOP must be designed to invest primarily in qualifying employer securities.²⁵ *Qualifying employer securities* are shares of common stock issued by the employer (or a member of the same controlled group) (a) readily tradable on an established securities market, or, (b) in case there is no such readily tradable stock, having a combination of voting power and dividend rights at least equal to the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights. Noncallable preferred shares qualify also, if they are convertible into stock meeting the requirements of items a or b (as appropriate) and if the conversion price is reasonable at the time the shares are acquired by the plan.²⁶ In a General Counsel Memorandum, the IRS determined that the common stock of a corporation did not constitute employer securities with respect to the employees of a partnership owned by the corporation's subsidiary, because a partnership is not a corporate entity. As a result, the employees of the partnership could not participate in the corporation's ESOP.²⁷

Certain tax-exempt entities (such as a qualified retirement plan trust) are eligible to be shareholders of S corporations; consequently, S corporations may adopt ESOPs.²⁸ Special limits apply to an ESOP of an S corporation.

An ESOP may offer some significant tax advantages not available in other plan types, namely:

1. Certain loan transactions, including a loan guarantee, between the plan and the employer are exempt from the prohibited transaction rules that prohibit loans between plans and parties-in-interest.²⁹
2. Certain forfeitures and contributions are excluded from the annual additions limit.

²⁴ IRC Section 4975(e)(7); ERISA Section 407(c)(6).

²⁵ IRC Section 4975(e)(7).

²⁶ IRC Sections 4975(e)(8), 409(l).

²⁷ General Counsel Memorandum (GCM) 39880 (10-8-92).

²⁸ IRC Section 1361(c)(6); Senate Committee Report for SBJPA '96.

²⁹ IRC Section 4975(d)(3); ERISA § 408(b)(3).

3. Increased deductions by a C corporation employer are permitted on loan repayments.³⁰
4. Long-term capital gain on the sale of qualified securities³¹ may be deferred by purchasing replacement securities within a replacement period that begins three months before the date of sale to the ESOP and ending 12 months after the sale.³²
5. Exemptions apply in financing the acquisition of another company.
6. Presumably, though not always, ESOPs place stock in friendly hands.³³
7. Advantages apply if the ESP is used as an estate planning tool. The FMV of stock acquired by ESOP before death can be more easily determined, possibly reducing the chances of dispute with IRS. Purchase of shares from estate when the benefits of an IRS Section 303 redemption are not available, may result in no gain. Generally, the basis of the sold shares will equal the FMV on the date of death, and the purchase price paid (by corporation or ESOP) will likely be this amount.³⁴
8. ESOPs may provide a market for the securities of the controlling owner of a closely held corporation.

Pension Plans

A pension plan is established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement.³⁵ Thus, a pension plan may not permit the withdrawal of employer contributions or earnings thereon, even in the case of financial need, before death, disability, retirement, severance of employment, or termination of the plan.³⁶ However, withdrawals may be permitted once the employee has reached normal retirement age even if the employee has not actually retired.³⁷

For the same reasons, a pension plan may not permit the withdrawal of mandatory employee contributions or employee contributions to which employer contributions are geared (as in a hybrid money-purchase thrift plan) before retirement.³⁸ A pension plan may also permit an employee to withdraw nondeductible voluntary contributions without terminating membership in

³⁰ IRC Sections 404(a)(9)(c), 404(k).

³¹ IRC Sections 1042(b)(4), 1042(c)(1); Ltr. Ruls. 9830028 (Apr. 28, 1998), 921506 (Jan. 9, 1992), 9036039 (Jun. 13, 1990), but see, Ltr. Ruls. 200052014 (Jan 27, 2002, released Dec. 29, 2002) and 8910067 (Dec. 14, 1988) regarding stock not readily tradable (NASD pink sheet; over the counter securities (OTCBB)).

³² IRC Section 1042(c); Temp. Treas. Reg. _ 1.1042-1T, Q&A 3(c).

³³ NCR Corp v. AT&T, 761 F. Supp 475 (SD Ohio 1991); Menowitz v. NCR Corp, No. C-3-91-12 (SD Oh1991).

³⁴ IRC Section 302, 303, 1014, 6166.

³⁵ Treas. Reg. Section 1.401-1(b)(1)(i).

³⁶ Rev. Ruls. 69-277 (1969-1 CB 116), 74-417 (1974-2 CB 131).

³⁷ Rev. Rul. 71-24 (1971-1 CB 114), 73-448 (1973-2 CB 136).

³⁸ Rev. Ruls. 56-693 (1956-2 CB 282), 74-417 (1974-2 CB 131).

the plan, provided the withdrawal will not affect the member's participation in the plan, the employer's past or future contributions on the employee's behalf, or the basic benefits provided by both the participant's and the employer's compulsory contributions.³⁹

The requirement that the benefits be definitely determinable may be satisfied by providing for either fixed benefits (as a defined-benefit pension plan) or fixed contributions (as in some defined-contribution plans).

Under a defined-benefit plan which provides fixed benefits, the size of the pension, or a formula to determine the pension amount, is set in advance. Annual contributions are determined by actuarial methods that will gradually accumulate a fund sufficient to provide those benefits when each employee's pension is due, generally at retirement. The benefit amount or formula is generally related to compensation, years of service, or both.

Under a plan that provides for fixed contributions, such as a defined-contribution money-purchase pension plan, the annual contribution to an employee's account is fixed or definitely determinable, and the employee receives the funds accumulated in his or her account or whatever benefit can be purchased with those funds. Defined-contribution plans have individual accounts established for each participant that reflect their individual beneficial interests under the plan. The fixed contribution may not be geared to profits and is generally expressed as a percentage of each employee's compensation not in excess of \$205,000 (the 2004 limit).⁴⁰

A plan is not a pension plan if it provides for layoff, sickness, accident, hospitalization, or medical expenses (except medical expense benefits for retired employees). However, a pension plan may provide incidental death benefits, through life insurance or otherwise.⁴¹

Normal Retirement Age

The normal retirement age in a defined-benefit pension or annuity plan is the lowest age specified in the plan at which the employee has the right to retire without the consent of the employer and receive retirement benefits based on service to date of retirement at the full rate set forth in the plan (i.e., without actuarial or similar reduction because of retirement before some later specified age). Ordinarily, the normal retirement age under a defined-benefit pension and annuity plans is age 65, but a pension plan may provide for a normal retirement age of any age less than 65. If normal retirement age is less than age 62, and benefits begin before that age, the annual defined-benefit dollar limit (\$165,000 for 2004) must be actuarially reduced.⁴² Furthermore, it is required that the accrued benefit of an employee who retires after age 70½ be actuarially increased to take into account any period after age 70½ in which

³⁹ Rev. Rul. 60-323 (1960-2 CB 148), 69-277 (1969-1 CB 116).

⁴⁰ Treas. Reg. Section 1.401-1(a)(2)(i).

⁴¹ IRC Section 401(h); Treas. Regs. Sections 1.401-1(a)(2)(i), 1.401-1(b)(1)(i), 1.401-14.

⁴² IRC Section 415(b)(2)(C).

the employee was not receiving any benefits under the defined-benefit plan.⁴³ However, a pension plan may permit early retirement, and any reasonable optional early retirement age will generally be acceptable. Although a pension plan must provide primarily retirement benefits, a plan could provide for a lump-sum distribution to an employee who has reached both 59½ and the plan's normal retirement age, even if he continues to work for the employer.⁴⁴ Furthermore, a pension plan may provide for payment of the balance to the credit of an employee on plan termination.⁴⁵

Target-Benefit Plans

A target-benefit plan is a money-purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated benefit under the plan.⁴⁶ Under a target plan, allocations are generally weighted for age, and, in some cases, age and compensation.

Although a target-benefit plan is a type of defined-contribution plan, as a pension plan it is subject to the minimum funding requirements of IRC Section 412. Safe-harbor requirements for target plans are set forth in the cross-testing regulations under IRC Section 401(a)(4), under which a target plan will be deemed to be nondiscriminatory.⁴⁷

412(i) Plans

A 412(i) plan, or *fully insured plan*, is a defined-benefit plan that is exclusively funded with guaranteed investment contracts, retirement income annuities, and some forms of life insurance. If the contracts meet certain requirements, the plan will be exempt from the minimum funding requirements, quarterly contributions, and the actuarial statement, Form 5500, Schedule B. Underfunding is not an option and level annual premium payments must continue to the participant's retirement date. Because of lower rates of return, IRC Section 412(i) plans are front-loaded, and deduction amounts for a given benefit are higher, compensating, in part, for a less than market rate of return. IRC Section 412(i) plans are more fully discussed in Chapter 11, "Fully Insured Defined-Benefit Plans—Internal Revenue Code Section 412(i)."

It has been stated that the "412(i)—the good plan with the bad reputation—can do a lot for a smaller business owner's retirement package, but make sure they know what it shouldn't do."⁴⁸ Recent IRS guidance clarifies the types of contracts that are treated as abusive and their identification as a "possible listed transaction." The ideal candidate would be a self-employed individual, age 50 to 55, with few, if any, employees.

⁴³ IRC Section 401(a)(9)(C)(ii); see guidance in Temp. Treas. Reg. Section 1.401(a)(9)-6T, A-7.

⁴⁴ Treas. Reg. Section 1.401-1(b)(1); Ltr. Rul. 7740031 (Jul 11, 1977).

⁴⁵ IRC Section 401(a)(20).

⁴⁶ Treas. Reg. Section 1.401(a)(4)-8(b)(3)(i).

⁴⁷ Treas. Reg. Section 1.401(a)(4)-8(b)(3); Prop. Treas. Reg. Section 1.411(b)-2(c)(3)(iii).

⁴⁸ Gregory Taggart, "Using and Abusing the 412(i)," *Bloomberg Wealth Manager*, p 65 (January 2004).

A qualified-pension plan will not satisfy the requirements for an IRC Section 412(i) plan if it holds life insurance and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan. Further, employer contributions under a qualified defined-benefit plan that are used to purchase life insurance coverage for a participant in excess of that party's death benefit under the plan are not fully deductible when contributed. Instead, they are carried over to be treated as contributions in future years and deductible in future years when other plan contributions that are taken into account for the tax year are less than the maximum amount deductible for the year pursuant to the limits of IRC Section 404.

Such transactions have been identified as "listed transactions" effective February 13, 2004, provided that the employer deducted premiums paid on a contract for a participant with a death benefit that exceeds the participant's plan death benefit by more than \$100,000.⁴⁹

The IRS has made it clear that a 412(i) plan cannot use differences in life insurance contracts to discriminate in favor of HCEs. A plan that is funded, in whole or in part, with life insurance contracts will not satisfy the IRC Section 401(a)(4) nondiscrimination rules if:⁵⁰

1. The plan permits HCEs to purchase those life insurance contracts at cash surrender value prior to the distribution of retirement benefits.
2. Any rights under the plan for NHCEs to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of HCEs.

The IRS also warned that future guidance will limit the use of what it views as aggressive funding tactics. Characteristics of plans that the IRS views as abusive include unusually high expense loads and unusually low cash values in early policy years, resulting in high death benefits based on these values. These arrangements conclude with a contract loan or distribution sometime after the first five policy years, followed by a sharp increase in the policy cash value. The IRS has expressed the opinion informally that such arrangements are abusive, and that future guidance is expected to apply retroactively.

Practice Pointer: Arrangements have been promoted in which an employer establishes a 412(i) plan under which the deductible employer contributions are used to purchase a specially designed life insurance contract. Generally, these special policies are made available only to HCEs. The insurance contract is designed so that the cash surrender value is temporarily depressed, so that it is significantly below the premiums paid. The contract is distributed or sold to the employee

⁴⁹ Rev. Rul. 2004-20 (2004-10 IRB 546), modifying and superseding Rev. Rul. 55-748 (1955-2 CB 234).

⁵⁰ Rev. Rul. 2004-21 (2004-10 IRB 544).

for the amount of the current cash surrender value during the period the cash surrender value is depressed; however, the contract is structured so that the cash surrender value increases significantly after it is transferred to the employee. Use of this springing cash-value life insurance gives employers tax deductions for amounts far in excess of what the employee recognizes in income. See the discussion of FMV that prevents taxpayers from using artificial devices to understate the value of a life insurance contract.

Cash-Balance Plans

A cash-balance plan is a defined-benefit plan that calculates benefits in a manner similar to defined-contribution plans. It resembles a defined-contribution plan in that each employee has a hypothetical account or cash balance to which contributions and interest payments are credited. Nevertheless, because the actual funds are pooled, participant direction is not possible. Like other plans of the defined-benefit type, the employer bears both the risk and the benefits of investment performance.

Like other defined-benefit plans, a cash-balance plan defines an employee's retirement benefit by a formula, and the employee's retirement benefit does not depend either on the employer's contributions to the plan or on the investment performance of the plan's assets, as it would in a defined-contribution plan. A cash-balance plan defines an employee's benefit as the amount credited to an account, while other defined-benefit plans typically define an employee's benefit as a series of monthly payments.

Two federal courts issued rulings in 2003 against employers sponsoring cash-balance plans.⁵¹ The future of cash-balance plans and, especially, their use as a replacement for defined-benefit plans is under close scrutiny.

Legislative Proposals

The Bush Administration proposed legislation on February 12, 2004, addressing cash balance. The proposals cover three of the major issues of age discrimination, whipsaw (when the lump-sum value is larger than the cash-balance account the plan started with), and conversions of traditional pension plans into cash-balance plans. Each of the three proposals would be effective solely on a prospective basis from the date of enactment. It has also been proposed that the legislative history would state that there would be no inference as to the status of cash-balance plans or cash-balance conversions under current law.

1. *Age Discrimination Proposal.* The proposal would clarify that a cash-balance plan is not age discriminatory as long as it provides pay credits for older participants that are not less (as a percentage of pay) than

⁵¹ *Berger v. Xerox Corp.* 338 F.3d 755 (7th Cir. 2003); *Cooper v. IBM Personal Pension Plan*, 274 F.Supp. 2d (S.D. Ill. 2003). But, see, *Eaton v. Onan Corp.*, 117 F. Supp. 812 (S.D. Ind. 2000) regarding age discrimination. The area of the law is not well settled.

the pay credits for younger participants. Keep in mind that in *Cooper v. IBM*, the court took the view that cash-balance plans are inherently age discriminatory. In *Cooper*, the court reached that conclusion because pay credits that each participant earned each year were projected with interest to normal retirement age (generally, age 65), thereby taking into account all of the interest credits that were estimated to accumulate between the current year and normal retirement age. Because those future interest credits were taken into account in its age-discrimination analysis, the projected annuity benefits of younger participants were, under the *Cooper* court's analysis, greater than the projected annuity benefits of older participants having fewer years within which to benefit from interest compounding—thus, it was inherently discriminatory.

By contrast, the Bush proposal focuses on the pay credits, but does not convert the pay credits into normal retirement age benefits. The administration's proposal also would clarify that certain transition strategies used in cash-balance conversions (for example, preserving the value of early retirement subsidies in cash-balance accounts) are not age discriminatory or otherwise contrary to the tax-qualification rules. Similar rules would be provided for other types of hybrid plans, such as pension equity plans.

2. *Whipsaw Proposal*. When a traditional defined-benefit plan converts a participant's monthly retirement benefit to an actuarially equivalent lump-sum benefit, the plan must use an interest rate equal to the 30-year Treasury rate to perform the conversion. Cash-balance plans are designed to offer a lump-sum distribution that is equal to the participant's account balance under the plan. In 1996, the IRS announced that it was considering issuing a proposed regulation that might require the administrator of a cash-balance plan to perform an annuity-to-lump-sum conversion, even though a cash-balance plan defines the benefit as a single sum to begin with. If this approach were adopted, the cash-balance plan might be required to use the plan's interest crediting rate to convert the cash-balance account to an annuity, and then use the 30-year Treasury rate to convert the annuity back to a lump sum. If the cash-balance interest rate is higher than the 30-year Treasury rate on the date of the conversion, the conversion would produce a lump sum larger than the cash-balance account that the plan started with—an effect called *whipsaw*.

The Bush proposal would eliminate whipsaw, thereby allowing a cash-balance plan to distribute a participant's account balance as a lump-sum distribution, as long as the plan does not credit interest at a rate exceeding a market rate of return.

3. *Cash-Balance Conversions Proposal*. A traditional defined-benefit plan delivers most of its benefits toward the end of an employee's career. A cash-balance plan tends to distribute benefits more evenly throughout an employee's career. Absent a transition or greater of benefit struc-

ture, workers with many years of service might earn less after the switch than they would have earned had the traditional defined-benefit plan stayed in place. As the new benefit structure takes over there tends to be a wearing away of the so-called “frozen” benefit.

Under the Bush proposal, for each of the first five years after a conversion, the benefits earned by a current participant must be at least as valuable as the benefits that the participant would have earned if there had been no conversion, and there could be no wearing away of either the normal or the early retirement benefits at any time. These new requirements would be enforced by a 100-percent excise tax payable by the plan sponsor on any excess of the benefits required by the proposal over the benefits actually provided. Under the proposal, the excise tax would not apply in all situations, for example, the excise tax would be capped at the greater of (1) the value of plan’s surplus assets at the time of conversion or (2) the plan sponsor’s taxable income. Furthermore, the excise tax would not apply with respect to participants who are given a choice between the plan’s old formula and the new cash-balance formula and participants who are grandfathered under the plan’s old formula.

Eligibility and Minimum Participation Requirements

Both Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code contain standards regarding the minimum age and minimum length of service requirements that an employer may impose on employees before allowing them to participate in the employer’s qualified plan. Statutory exclusions are also available. Furthermore, participation requirements unrelated to age and service requirements may also be permitted if not discriminatory. Both the provisions of the plan and the plan in operation must satisfy the minimum participation (and vesting standards).

Minimum Age and Service Requirements

A qualified plan may not require, as a condition of participation in the plan, that an employee complete a period of service extending beyond the later of (1) age 21, or (2) the completion of one year of service or the completion of two years of service if the plan provides that after not more than two years of service each participant has a nonforfeitable right to 100 percent of his or her accrued benefit.⁵² If a plan is maintained exclusively for employees of an IRC Section 501(a) tax-exempt educational institution, the minimum age limitation can be 26 instead of 21, but only if the plan provides that each participant having at least one year of service has a nonforfeitable right to 100 percent of his or her accrued benefit.⁵³ A plan generally may not exclude from participation in the plan an employee who is beyond a specified age.⁵⁴ A plan may pro-

⁵² IRC Section 410(a).

⁵³ IRC Sections 401(a)(3), 410(a)(1); Temp. Treas. Reg. Section 1.410(a)-3T.

⁵⁴ IRC Section 410(a)(2).

vide more liberal eligibility requirements—for example, no age or service requirements—in which case participants would become eligible on their date of hire. The minimum age requirement must be satisfied before the commencement of participation rules are applied. Thus, unless a plan provides for retroactive participation or a “nearest to” entry date, a participant will have generally attained the age requirement, if any is specified, on or before the date participation is to commence.

Two-Year Service Requirement

Instead of requiring one year of service, a plan that provides 100-percent vesting may require that an employee complete two years of service to share in any employer matching or discretionary profit-sharing contributions.⁵⁵ Employers with high turnover following initial employment may find the two-year rule more advantageous than a vesting schedule. The two-year rule does not apply to elective contributions made by a participant in a 401(k) plan. Thus, the plan may have to provide for a one-year of service requirement for elective contributions, while providing for a two-year requirement for employer derived contributions. Using overlapping eligibility computation periods may result in an eligibility period of less than two years. Generally, dual-eligibility plans will use each employee's employment years as that employee's computation period. However, top-heavy contributions (if required) would have to be made for all participants, including those participants only eligible to make elective contributions. Vesting and nonforfeitability is discussed later in this chapter.

The term *accrued benefit* means, in the case of a defined-benefit plan, the employee's accrued benefit determined under the plan expressed in the form of an annual benefit commencing at normal retirement age, or, in the case of any other kind of plan, the balance of the employee's account.⁵⁶ Generally, the accrued benefit of a participant may not be decreased by an amendment to the plan.

Commencement of Participation

A qualified plan must provide that any employee who has satisfied the minimum age and service requirements (discussed below) and who is otherwise entitled to participate in the plan is to commence participation in the plan no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied such requirements, or (2) the date six months after the date on which he satisfied such requirements, unless the employee was separated from service before whichever date is applicable.⁵⁷ Additional requirements, not related to age or service, may be imposed by a qualified plan as a condition of participation, provided it does not have the effect of imposing an additional age or service requirement (even if the provision

⁵⁵ IRC Section 410(a)(1)(B)(i).

⁵⁶ IRC Section 411(a); Treas. Reg. Section 1.411(a)-7.

⁵⁷ IRC Section 410(a)(4); Treas. Reg. Section 1.410(a)-4(b)(1); Rev. Rul. 80-360 (1980-2 CB 142), see illustrations of entry dates.

does not specifically refer to age or service).⁵⁸ Most qualified plans provide for semiannual entry dates following satisfaction of the age and service requirement, some provide for a “nearest to” annual entry date. Other schemes are acceptable, so long as it is not possible for the commencement of participation to be deferred beyond the later of dates indicated above.

Example. A plan provides for a participant to commence participation on the plan’s annual entry *next following* their completion of a year of service and attainment of age 21. The plan is not a qualified plan. For example, a full-time employee who turns age 21 during the year (or on an entry) date might have to wait more than six months to commence participation.

Example. Over and Up are divisions of the same company. New employee apprentices are initially hired by Over for four years and then transferred to Up. A plan provision that requires employment in Over is a disguised service requirement.

Example. A qualified plan that excludes part-time employees from plan participation will violate the IRC Section 410 participation rules if it is possible that such an employee could complete the requirement of 1,000 hours and one year of service. (See the following section for a full discussion.)⁵⁹

Year of Service

The term *year of service* means a 12-month period, measured from the date the employee enters service, during which the employee has worked at least 1,000 hours; special rules apply if there are breaks in service and there is absence from work due to pregnancy, childbirth, or adoption of a child.⁶⁰ Special rules also apply in the cases of seasonal industries and maritime industries.⁶¹ A provision excluding part-time employees is not permitted in a qualified plan.

The initial eligibility period ends on the date that is one year after the date of employment. To avoid burdensome recordkeeping, a plan may provide that subsequent eligibility computation periods be shifted to the plan year, instead of continuing to be based on employment years. If eligibility periods overlap, however, an employee must be credited with a year of service during each of the overlapping computation periods in which the 1,000 hours of service are completed.

Example. A qualified profit-sharing plan provides an employee to complete one year of service to be eligible to participate in the plan. The term *year of service* is defined by the plan as the completion of 1,000 hours of service

⁵⁸ Treas. Reg. Section 1.410(a)-3(d), 1.410(a)-3(e)(1).

⁵⁹ Rul. Ltr. 9508003 (Nov. 10, 1994) retroactive disqualification of new plan avoided by timely amendment.

⁶⁰ IRC Sections 410(a)(3), 410(a)(5); Treas. Regs. Sections 1.410(a)-5, 1.410(a)-6, 1.410(a)-9; Temp. Treas. Reg. Section 1.410(a)-8T.

⁶¹ IRC Sections 410(a)(3)(B), 410(a)(3)(D); Treas. Reg. Section 1.410(a)-5. No guidance has been issued with respect to seasonal employees, but see, DOL Reg. § 2530.200b-6 regarding maritime employees where 125 hours of service is generally required to complete one-year of service.

during the 12-month period commencing on an employee's date of hire. The plan provides that if an employee does not satisfy the requirements for eligibility during that period, then the subsequent 12-month period will shift to the plan year that includes the last day of the initial eligibility period. The plan year is defined as the calendar year. The plan provides that an eligible employee (i.e., an employee that completes a year of service) commences participation on the January 1, or June 1, semiannual entry date following their satisfaction of the eligibility requirement.

Mary commences employment on June 1, 2003. During the next 12 months (ending on May 31, 2004), Mary completes 800 hours of service. So far, Mary is not eligible to participate. For the 12-month period beginning on January 1, 2004 (the overlapping computation period) she completes 1,000 hours of service. Mary is eligible, her participation will commence on the January 1, 2005, entry date; that is, the next entry date after the end of the 12-month computation period (in which she completed her year of service) provided she is employed on that date and has satisfied the plan's age requirement. Mary is credited with one year of eligibility service.

Example. Same facts as in the preceding example, except Mary completes 1,000 hours of service during her initial computation period. Mary's participation will commence on June 1, 2003; the next entry date following her completion of a year of service provided she is employed on that date and satisfied the plan's age requirement. Mary is credit with two years of eligibility service.

If the computation period is less than 12 months, hours must be disregarded and an elapsed time method must be used. An employee that is terminated before his or her participation begins, but after completing the 1,000-hour year of service eligibility requirement, is deemed not to have begun participation in the plan.⁶²

Past Service With Former Employer

Past service with former employers may be used for the purpose of determining eligibility to participate in a plan provided (1) the former employers are specified in the plan or trust, (2) all employees having such past service are treated uniformly, and (3) the use of the past service factor does not produce discrimination in favor of the HCEs.⁶³ Credit for service may also be credited for services performed as partners or sole proprietors prior to becoming employees in a successor corporation for participation purposes.⁶⁴

Service for Predecessor Employer

If an employer maintains a plan of a predecessor employer, service for such predecessor shall be treated as service for the employer. If an employer maintains a plan which is not the plan maintained by a predecessor employer, service for such predecessor shall, to the extent provided in regulations pre-

⁶² Treas. Reg. Section 1.410(a)-4(b); DOL Reg. Section 2530.200b-1(b).

⁶³ Rev. Rul. 72-5 (1972-1 CB 106).

⁶⁴ Let. Rul. 7742003 (no date available).

scribed by the Secretary of the Treasury, be treated as service for the employer.⁶⁵

Related Employer Service Rules

All employees of all corporations which are members of a controlled group of corporations (within the meaning of IRC Section 1563(a), determined without regard to IRC Sections 1563(a)(4) and (e)(3)(C)) shall be treated as employed by a single employer. With respect to a plan adopted by more than one such corporation, the applicable deduction limitations shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary of the Treasury. Similar rules apply to partnerships and sole proprietorships.⁶⁶

Hours of Service

Depending upon the method of counting hours and crediting service, an employer can structure a plan to favor one group of employees over another group. In addition, the number and structure of plan participants could also change depending upon which method is used. Careful analysis and/or educated guesswork is often needed to determine the most suitable plan design.

An hour of service is generally each hour for which an employee is paid or entitled to compensation, either with respect to the performance of duties or for reasons, such as vacation, sick leave, holiday, jury duty, military duty, and so on.⁶⁷ Any hour for which the employee receives back pay is an hour of service and must be credited to the computation period to which the back pay pertains.

Hours of service does not have to be credited for compensation maintained under a plan that is solely for the purpose of complying with worker's compensation, unemployment compensation, or disability insurance laws.⁶⁸ Neither do hours have to be credited for any hour for which the employee is reimbursed for medical expenses.⁶⁹

Hours also have to be credited when no duties are performed and the employee is entitled to compensation. However, not more than 501 hours are required to be credited to an employee who performs no duties during the year. If no duties are performed, payment generally is based on units of time (e.g., hours, days, weeks, or months). The hours to be credited are the regularly scheduled working hours on which the payment is based. For an employee without a regular work schedule, a plan may provide for the number of hours to be calculated based on a 40-hour workweek or an eight-hour day, or on any reasonable basis that is consistently applied and reflect the average hours worked by the employee or by other employees in the same job classification

⁶⁵ IRC Section 414(a)(1)-(2).

⁶⁶ IRC Section 414(b).

⁶⁷ IRC Section 410(a)(3)(C); DOL Reg. Section 2530.200b-2.

⁶⁸ DOL Reg. Section 2530.200b-2(a)(2)(ii).

⁶⁹ DOL Reg. Section 2530.200b-2(a)(iii).

over a representative time period.⁷⁰ If payment is made in a lump sum; that is, not based on units of time, the hours to be credited are computed by dividing the lump-sum payment by the employee's most recent hourly rate of compensation prior to the period for which no duties were performed.⁷¹

A plan could provide for crediting service using an equivalency method or under an elapsed time method, rather than actual hours.

Equivalency Method

To simplify administration, a plan could provide for crediting service using the equivalency method (rather than the actual hour method) provided it is not discriminatory and consistently applied. For example, the equivalency method could be used for exempt employees, and the actual hours method for nonexempt employees. In some cases, under the equivalency method, nonperformance hours are disregarded. This may be advantageous in some situations. Equivalencies can be based on hours worked, periods of employment, regular time hours, or periods of employment, each of which is discussed in the following sections.

Hours Worked Method⁷²

This method does not take into account hours for which no duties are performed; such as, vacation, sick leave, holiday, jury duty, military duty, and so on. Because employees might be credited with fewer hours, under this method, a year of service requires the completion of a fewer number of hours, as shown in the following:

Credit For	Hours Required
Year of Service	870
500 hours	435
501 hours	436 (to avoid a one-year break in service)

Example. A qualified plan uses the equivalency method based on hours worked. Melissa, a full-time employee, completed 490 hours of service before she was called be a juror in a criminal trial. Melissa was paid by her employer at her regular rate while she was on jury duty, but did not return until after the end of the initial computation period. She has not completed a year of service during this computation period. Under this method, Melissa is only credited with the 490 hours she worked, but has not incurred a break in service because she completed 436 hours under this method. Melissa did not perform any duties as a juror, so those hours for which she was paid are disregarded.

⁷⁰ DOL Reg. Section 2530.200b-2(b)(1).

⁷¹ DOL Reg. Section 2530.200b-2(b)(2).

⁷² DOL Reg. Section 2530.200b-3(d)(1).

*Equivalencies Based on Earnings*⁷³

Under this method, hours of service are determined by converting an employee's compensation into hours of service. An hourly employee's compensation is divided by their hourly rate, as shown in the following:

Credit For	Hours Required
Year of Service	870
500 hours	435
501 hours	436 (to avoid a one-year break in service)

Example. A qualified plan uses the equivalency method based on earnings. During the computation period, Joe earns \$10,900 at his \$25 hourly rate. His 436 hours ($\$10,900 / 25$) are sufficient to avoid a one-year break in service, but Joe has not completed the 870 hours needed to complete a year of service this computation period.

Similar rules are provided under the regulations for nonhourly employees. An hourly rate is arrived at, and hours are determined based on compensation. For a nonhourly employee, however, fewer hours are required to complete a year of service, as follows:

Credit For	Hours Required
Year of Service	750
500 hours	375
501 hours	376 (to avoid a one-year break in service)

*Periods of Employment Method*⁷⁴

Under this method, the number of hours of service to be credited is based on the following periods in which the employee received at least one hour of service, as shown in the following:

Period Worked During	Hours Credited	Full-Time Employee Estimated Hours With No Leave
Day	10	2,600 (10 x 260 days)
Week	45	2,340 (45 x 52 weeks)
Semimonthly period	95	2,280 (95 x 24 pay period)
Month	190	2,280 (190 x 12 months)

⁷³ DOL Reg. Section 2530.200b-3(f).

⁷⁴ DOL Reg. Section 2530.200b-3(e).

The weekly equivalency of 45 hours generally credits an employee with the least number of hours.

Example. A qualified plan uses the equivalency method based on periods of employment. Forty-five hours are credited for each week in which at least one hour of service is credited. Billy works three hours on Sunday and continues to do so for 24 weeks during the computation period. He is credited with 1,080 hours, more than the 1,000 hours required to receive credit for a year of service.

*Regular Time Hours Method*⁷⁵

The hours worked method does not take into account any hours for which the employee did not perform any duties. Under this method, only regular time hours are considered; overtime hours are ignored, as shown in the following:

Hours Required	Credit For
750	Year of Service
375	500 hours
376	501 hours (to avoid a one-year break in service)

Example. A qualified plan uses the equivalency method based on regular hours worked. During the relevant computation period George worked 375 regular hours and completed 30 overtime hours. George will only be credited with 375 hours and has incurred a one-year break in service; he worked less than 376 hours, the 501-hour equivalency.

*Elapsed Time Method*⁷⁶

Under this method, service is based on an employee’s period of service beginning on the date employment begins and ends on the earlier of the following dates:

- 1. The date the employee quits, dies, retires, or is discharged
- 2. The first anniversary of the first day of a period of absence from service for any other reason, such as vacation, holiday, layoff, or disability

If an employee separates for any reason other than quitting, retiring, or being discharged, and returns to work within 12 months, the severance period is included within the period of service.

Example. A qualified plan uses the equivalency method based on elapsed time. Holly commences employment on January 1 and is laid off five months later on May 31. She is rehired six months later on November 1 and continues

⁷⁵ DOL Reg. Section 2530.200b-3(d)(2).
⁷⁶ Treas. Reg. Section 1.410(a)-7. Not contained in DOL regulations under ERISA.

in her employment indefinitely. Holly will complete a year of service on December 31.

Caution: *Using an equivalency method for some purposes under a plan and the actual hours method for other purposes (although it is permitted for crediting service) may result in discrimination in operation and generally should be avoided.*

Break in Service

In general, all years of service with an employer are taken into account for eligibility purposes. However, years in which an employee incurs a break in service generally can be ignored.

A *one-year break in service* is a calendar year, plan year, or other 12-month period designated by the plan during which the employee completes fewer than 501 hours of service.⁷⁷ As previously discussed, however, fewer hours are required under some of the elapsed time methods of crediting hours of service for purposes of receiving credit for a year of service and for incurring a break in service (e.g., 376 or 436 hours); another ignores certain breaks of less than 12 months in duration.

It is often difficult to predict the effect that a break in service will have on eligibility or vesting. Nonetheless, the break in service rules are a factor that may be able to be considered in some well-defined industries and businesses that have maintained such history and records. Simply factoring in several weeks or months of consecutive vacation or other leave will not always produce the same effect as when the same amount of leave is spread out over different periods. Special care must be taken in determining service in seasonal and maritime industries, previously discussed.

Minimum Coverage Requirements

A qualified plan is discriminatory unless it satisfies either a ratio-percentage test, a ratio-percentage test, or an average-benefits test.⁷⁸

Percentage Tests

A qualified plan must benefit either:

1. 70 percent of all NHCEs, according to the percentage test, or
2. A percentage of the NHCEs that is at least 70 percent of the percentage of HCEs benefiting under the plan, that is, the ratio test.⁷⁹

⁷⁷ IRC Section 410(a)(5). A similar rule applies for vesting purposes, see IRC Section 411(a)(6)(A); DOL Reg. Section 2530.200b-4.

⁷⁸ Governmental plans are exempt from the participation requirements. IRC Section 401(a)(5)(G), 410(c)(1)(A); Notice 2003-6 (2003-3 IRB 298).

⁷⁹ IRC Section 410(b)(1).

A plan's ratio percentage is determined by dividing the percentage of the NHCEs who benefit under the plan by the percentage of the HCEs who benefit under the plan.⁸⁰

Example. Cobalt Company has a profit-sharing plan that covers 30 of its 100 nonexcludable HCEs and 85 of its 100 nonexcludable NHCEs. The plan's ratio percentage is computed as follows:

The percentage of the HCEs who benefit under the plan can be computed as follows:

$$\frac{30/50}{85/100} = \frac{.60}{.85} = 70.58$$

Cobalt's ratio percentage is 70.58 percent; thus, it passes the ratio percentage test (even though the percentage test is not satisfied).

Example. Same facts as in the preceding example, except 90 nonexcludable HCEs are covered. Here, the ratio test is not satisfied; .6 divided by .9 equals 66.6 percent, which is less than 70 percent. Perhaps the plan can pass the average-benefits test.

Average-Benefits Test

A plan that cannot satisfy the ratio percentage test may still pass the coverage requirement by satisfying the average-benefits test. There are two elements of the average-benefits test and both must be met for a plan to satisfy the average-benefits test.⁸¹ The two components are:

- The nondiscriminatory classification test, and
- The average-benefits percentage test

Nondiscriminatory Classification Test

In order to pass the nondiscriminatory classification test, a plan must benefit "such employees as qualify under a classification set up by the employer and found by the Secretary [of the Treasury] not to be discriminatory in favor of highly compensated employees."⁸² Regulations require that (1) the classification of employees must be reasonable and reflect a bona fide business classification of employees, and (2) the classification must be nondiscriminatory, based on a facts and circumstances test or a safe-harbor percentage test (explained below).⁸³

⁸⁰ Treas. Reg. Section 1.410(b)-9.

⁸¹ IRC Section 410(b)(2); Treas. Reg. Section 1.410(b)-2(b)(3).

⁸² IRC Section 410(b)(2)(A)(i).

⁸³ Treas. Reg. Section 1.410(b)-4(b), 1.410(b)-4(c).

To determine whether a classification is nondiscriminatory, the plan's ratio percentage (as defined above) is compared to a table (see below) that is set forth in the regulations. This comparison produces one of three results:

1. If the plan's ratio percentage falls below the unsafe-harbor percentage, it is discriminatory.
2. If the plan's ratio percentage falls between the safe-harbor and unsafe-harbor amounts, it must satisfy a facts and circumstances test.
3. If the plan's ratio percentage falls at or above the safe-harbor amount, the plan is nondiscriminatory.⁸⁴

The regulations contain a table setting forth a safe-harbor percentage and an unsafe-harbor percentage for every NHCE concentration level.⁸⁵ The table begins with an NHCE concentration of zero to 60 percent, and for that level provides a safe-harbor percentage of 50 percent and an unsafe-harbor percentage of 40 percent. In other words, for an employer with 100 employees, of whom 40 are highly compensated and only 60 are nonhighly compensated, the classification would automatically be nondiscriminatory under the safe harbor if its ratio percentage were 50 percent or higher. See Chapters 8, "Internal Revenue Code 401(k) and Safe-Harbor 401(k) Plan Design," and 9, "Defined-Contribution Cross-Tested and General Tested Plan Design," for more information on defined-contribution plan design.

The following table sets forth the safe-harbor and unsafe-harbor percentages at each NHCE concentration percentage:

NHCE Safe-Harbor Concentration Percentage	Unsafe-Harbor Percentage	Percentage
0–60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75

(continued)

⁸⁴ Treas. Reg. Section 1.410(b)-4(c).

⁸⁵ Treas. Reg. Section 1.410(b)-4(c)(4)(iv).

NHCE Safe-Harbor Concentration Percentage	Unsafe-Harbor Percentage	Percentage
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

Under the table,⁸⁶ the safe-harbor percentage is reduced by three-quarters of a percentage point (but not below 20.75 percent) for each whole percentage point by which the NHCE concentration percentage exceeds 60 percent. Thus, for an employer with a NHCE concentration percentage of 99 percent, the safe-harbor percentage would be 20.75 percent.⁸⁷ The unsafe-harbor percentage is reduced by three-quarters of a percentage point (but not below 20 per-

⁸⁶ Treas. Reg. Section 1.410(b)-4(c)(4)(iv).

⁸⁷ Treas. Reg. Section 1.410(b)-4(c)(2), 1.410(b)-4(c)(4)(i).

cent) for every whole percentage point by which the NHCE concentration percentage exceeds 60 percent.⁸⁸

Example. Blade Corporation has 200 nonexcludable employees, of whom 120 are NHCEs and 80 are HCEs. Blade maintains a plan that benefits 60 NHCEs and 72 HCEs. Thus, the plan's ratio percentage is 55.56 percent ($[60/120]/[72/80]$), which is below the percentage necessary to satisfy the non-discriminatory ratio percentage test. Blade's NHCE concentration percentage is 60 percent ($120/200$); thus, Blade's safe-harbor percentage is 50 percent and its unsafe-harbor percentage is 40 percent. Because the plan's ratio percentage (55.56 percent) is greater than the safe-harbor percentage (50 percent), the plan's classification satisfies the safe harbor.⁸⁹

Example. Same facts as in the preceding example, except that the plan only benefits 40 NHCEs. The plan's ratio percentage is 37.03 percent ($[40/120]/[72/80]$). The plan's classification is below the unsafe-harbor percentage of 40 percent.⁹⁰

Average-Benefits Percentage Test

The second part of the average-benefits test requires that the average-benefits percentage for NHCEs be at least 70 percent of the average-benefits percentage for HCEs.⁹¹

An employee's benefit percentage is his employer-provided contributions (including forfeitures and elective contributions) or benefits under all qualified plans maintained by the employer, expressed as a percentage of his or her compensation.⁹² Employee contributions and benefits attributable to employee contributions are not taken into account in calculating employee benefit percentages.⁹³ The regulations permit benefit percentages to be determined on either a contributions or a benefits basis, but the benefit percentages for any testing period must be determined in the same manner for all plans in the testing group.⁹⁴ A plan maintained by an employer that has no employees other than HCEs for any year or that benefits no active HCEs for any year is treated as meeting the minimum coverage requirements.⁹⁵

The average-benefits percentage means the average of the benefit percentages calculated separately with regard to each employee in the group.⁹⁶ All of an employer's qualified plans must be considered in determining benefit percentages, even if the plan—standing alone—satisfies the percentage test or

⁸⁸ Treas. Reg. Section 1.410(b)-4(c)(4)(ii).

⁸⁹ Treas. Reg. Section 1.410(b)-4(c)(5), ex 1.

⁹⁰ Treas. Reg. Section 1.410(b)-4(c)(5), ex 2.

⁹¹ IRC Section 410(b)(2)(A)(ii); Treas. Reg. Section 1.410(b)-5(a).

⁹² IRC Section 410(b)(2)(C)(i).

⁹³ Treas. Reg. Section 1.410(b)-5(d)(2).

⁹⁴ Treas. Reg. Section 1.410(b)-5(d)(5).

⁹⁵ IRC Section 410(b)(6)(F); Treas. Regs. Section 1.410(b)-2(b)(5), 1.410(b)-2(b)(6).

⁹⁶ IRC Section 410(b)(2)(B); Treas. Reg. Section 1.410(b)-5.

the ratio test. Nonetheless, an employer who maintains separate lines of business (see below) may test those businesses separately.

The benefit percentage for any plan year is computed on the basis of contributions or benefits for that year or, at the election of the employer, any consecutive plan year period (up to three years) ending with the plan year and specified in the election. An election under this provision cannot be revoked or modified without the consent of the Secretary of the Treasury.⁹⁷

Separate Lines of Business Exception

An employer who operates “separate lines of business” may apply the above tests separately with respect to employees in each line of business, so long as any such plan benefits a class of employees that is determined, on a company-wide basis, not to be discriminatory in favor of HCEs.⁹⁸ A separate line of business exists if the employer, for bona fide business reasons, maintains separate lines of business or operating units. A separate line of business, however, cannot have less than 50 employees (disregarding any employees excluded from the top-paid group when determining which employees are highly compensated). A separate line of business must also either meet a statutory safe harbor (with regard to ratios of HCEs) provided in the Code, meet one of the administrative safe harbors provided in final regulations, or request and receive an individual determination from the IRS that the separate line of business satisfies administrative scrutiny.⁹⁹

Statutory Exclusions

Employees who can be excluded from consideration by statute in meeting the coverage tests generally include:

1. Employees covered by a collective bargaining agreement (provided that retirement benefits were the subject of good-faith bargaining between the employee representatives and the employer)
2. Nonresident aliens who receive no U.S. earned income¹⁰⁰

Waiver of Participation

Although a plan may permit an otherwise eligible employee to waive his or her right to participate, such a waiver may, under some circumstances, result in discriminatory coverage.¹⁰¹

⁹⁷ IRC Section 410(b)(2)(C).

⁹⁸ IRC Section 410(b)(5).

⁹⁹ IRC Section 414(r); Treas. Regs. Sections 1.414(r)-5, 1.414(r)-6.

¹⁰⁰ IRC Section 410(b)(3); Treas. Regs. Sections 1.410(b)-6(d), 1.410(b)-9.

¹⁰¹ Rev. Rul. 80-351 (1980-2 CB 152).

Former Employees

Active and former employees are tested separately for purposes of these rules.¹⁰² A plan satisfies the coverage requirement with respect to former employees only if, under all the relevant facts and circumstances, the group of former employees does not discriminate significantly in favor of HCEs.¹⁰³

If a plan applies minimum age and service conditions for eligibility purposes and excludes all employees who do not satisfy those conditions, then all employees who fail to satisfy those requirements are excludable employees with respect to that plan. However, such an employee may be treated as an excluded employee if he or she terminates employment with not more than 500 hours of service.¹⁰⁴

Employees Treated as Benefiting

Generally, for purposes of meeting the above tests, an employee benefits under a plan for a year only if the employee accrues a benefit or receives an allocation under the plan for that year. However, in the case of a 401(k) plan, any individual who is eligible to make elective contributions is treated as benefiting under the plan (See Treasury Regulations Section 1.410(b)-3(a).)

Mandatory Disaggregation

In some cases, a plan or portions of a plan must be disaggregated for purposes of meeting the minimum coverage rules. The mandatory disaggregation requirement requires that certain single plans must be treated as comprising separate plans, each of which is subject to the minimum coverage requirements. The following generally have to be tested separately for coverage purposes:

1. The portion of a plan that includes a cash or deferred arrangement subject to IRC Section 401(k) (or matching and employee after-tax contributions subject to IRC Section 401(m)) and the portion that does not
2. The portion of a plan that benefits otherwise excludable employees and the portion that does not
3. The portion of a plan that benefits employees under a collective bargaining arrangement and the portion that benefits nonunion employees
4. A plan that benefits the employees of a separate line of business and any plan maintained by any other line of business if the employer elects to use the separate line of business rules

¹⁰² Treas. Reg. Section 1.410(b)-2(a).

¹⁰³ Treas. Reg. Section 1.410(b)-2(c)(2).

¹⁰⁴ Treas. Reg. Section 1.410(b)-6(f)(1).

5. The portion of a plan that is an ESOP and the portion that is a non-ESOP

For testing the benefits of employees who change from one qualified separate line of business to another, a reasonable treatment must be used.¹⁰⁵

Permissive Aggregation

For purposes of applying the ratio percentage test and the nondiscriminatory classification test, an employer may elect to designate two or more of its plans as a single plan, but only if the plans have the same plan years.¹⁰⁶

Defined-Benefit 50/40 Test

A defined-benefit plan must also satisfy the 50/40 test. A defined-benefit plan must benefit the lesser of the following:

1. 50 employees
2. The greater of 40 percent of all employees or two employees (or if there is only one employee, that employee), according to IRC Section 401(a)(26)

A defined-benefit plan must meet the participation requirement on each day of the plan year; however, under a simplified testing method, a plan is treated as satisfying this test if it satisfies it on any single day during the plan year so long as that day is reasonably representative of the employer's work force and the plan's coverage. A plan does not have to be tested on the same day each plan year. The regulations also provide that a plan that does not satisfy the test for a plan year may be amended by the fifteenth day of the tenth month after the close of the plan year to satisfy the test retroactively.¹⁰⁷

Cross-Tested Plans

When a defined-contribution plan is a cross-tested plan for nondiscrimination, benefits are taken into account (rather than contributions). Similarly, a defined-benefit plan is cross-tested based on contributions (rather than benefits). These plans are also called age weighted because they generally result in higher contribution rates for older employees. However, age weighing is also available without cross-testing, under a uniform points allocation formula safe harbor for defined-contribution plans. The general rules for converting allocations under a defined-contribution plan to equivalent benefits and for converting benefits under a defined-benefit plan to equivalent allocation rates are explained in the Treasury Regulations.¹⁰⁸

¹⁰⁵ Treas. Reg. Section 1.410(b)-7(c)(4)(i)(D).

¹⁰⁶ Treas. Regs. Sections 1.410(b)-7(d)(1), 1.410(b)-7(d)(5).

¹⁰⁷ Treas. Reg. Sections 1.401(a)(4)-11(g), 1.401(a)(26)-7(c).

¹⁰⁸ See Treas. Reg. Sections 1.401(a)(4)-8.

The most common form of cross-testing is called *new comparability*. The new comparability feature uses cross-testing to show that contributions under a profit-sharing plan provide nondiscriminatory benefits. Cross-testing can also involve aggregating a defined-benefit plan with a defined-contribution plan, and testing the plans together on the basis of the benefits they provide. Cross-tested and general tested plan designs are more fully discussed in Chapter 9.

Contributions

At this point, the identity of participants has been determined. How contributions are made and allocated must be considered in the plan's design. Generally, a small business owner's objective in allocating contributions is to provide greater benefits for more HCEs and/or key employees, while reducing the costs associated with contributions for all others. Consideration must also be given to forfeitures (generally contributions or benefits that are forfeited under the plan's vesting schedule) after the occurrence of a break in service. Contributions made under a plan can not be discriminatory in favor of HCEs.

Employees not included in the plan but who are covered by a collective bargaining agreement can be excluded from consideration in meeting the nondiscrimination requirement if there is evidence that retirement benefits were the subject of good-faith bargaining between the employee representatives and the employer; however, if the union employees are covered under the plan, benefits or contributions must be provided for them on a nondiscriminatory basis. Nonresident aliens with no U.S. earned income may also be excluded.¹⁰⁹

The exclusive rules for determining whether a plan satisfies the nondiscrimination requirements are contained regulations under IRC Section 401(a)(4).¹¹⁰ It is not required that both contributions and benefits be nondiscriminatory. A plan may satisfy this requirement on the basis of either contributions or benefits, regardless of whether the plan is a defined-benefit plan or a defined-contribution plan. The process of testing defined-benefit plans on the basis of contributions or defined-contribution plans on the basis of benefits is referred to as cross-testing.

A plan will not be considered discriminatory merely because contributions or benefits bear a uniform relationship to the employees' compensation.¹¹¹ IRC Section 401(a)(4) is satisfied only if the plan complies both in form and in actual operation with its regulations; intent is irrelevant.¹¹² A plan sponsor has two basic options for ascertaining that a plan provides nondiscriminatory contributions or benefits:

¹⁰⁹ IRC Sections 401(a)(4), 410(b)(3); Ltr. Rul. 8419001 (Dec. 7, 1983).

¹¹⁰ Treas. Reg. Section 1.401(a)(4)-1(a).

¹¹¹ IRC Section 401(a)(5)(B).

¹¹² Treas. Reg. Section 1.401(a)(4)-1(a).

- Design the plan to meet one of the safe harbors.
- Pass the general test on an annual basis.

A plan that does not meet the requirements for one of the safe harbors must use the general test. The safe-harbor methods are design-based; essentially, they require the plan to have uniformity provisions that reduce the risk of discrimination. As a result, annual testing is unnecessary. Practitioners will find that the safe harbors are simpler and less costly to apply than the general test, which requires annual review and focuses on actual plan results (rather than plan design).

Defined-Contribution Safe Harbors

The regulations set forth two safe-harbor designs for defined-contribution plans. Neither of the safe harbors allows the use of permitted disparity. A safe-harbor design is either based on the following:

1. *Uniform Allocation Formula.* A defined-contribution plan will be non-discriminatory if it allocates employer contributions and forfeitures for the year under an allocation formula that allocates to each employee (a) the same percentage of plan year compensation, (b) the same dollar amount, or (c) the same dollar amount for each uniform unit of service (not exceeding one week) performed by the employee during the year.¹¹³
2. *Uniform Points Allocation Formula.* Such a formula allows a defined-contribution plan (other than an ESOP) to be nondiscriminatory even though contributions are weighted for age and/or service, as well as for compensation.¹¹⁴

The use of either of these safe harbors is not precluded by a plan that has nonuniform benefits if the sole reason for the nonuniformity is that the plan provides lower benefits to HCEs than to other employees.¹¹⁵

General Test for Defined-Contribution Plans

Defined-contribution plans (other than plans subject to IRC Section 401(k) or 401(m)) that do not satisfy one of the safe harbors generally will meet the *nondiscrimination in amount* requirement only if each rate group satisfies the minimum coverage requirements of IRC Section 410(b). For this purpose, a *rate group* exists for each HCE in the plan, and consists of the HCE and all other employees in the plan (whether highly compensated or nonhighly compensated) who have an allocation rate greater than or equal to the HCE's allocation rate. In other words, each employee, regardless of compensation level,

¹¹³ Treas. Reg. Section 1.401(a)(4)-2(b)(2).

¹¹⁴ Treas. Reg. Section 1.401(a)(4)-2(b)(3).

¹¹⁵ Treas. Reg. Section 1.401(a)(4)-2(b)(4)(v).

is in the rate group for every HCE who has an allocation rate less than or equal to that employee's allocation rate.¹¹⁶

Defined-Benefit Safe Harbors

The regulations provide a set of uniformity requirements that apply to all of the defined-benefit safe harbors. Generally, the plan must provide a uniform normal retirement benefit in the same form for all employees, using a uniform normal retirement age. For purposes of this requirement, the Social Security retirement age will be treated as a uniform retirement age. The regulations provide for three safe harbors, namely, one for unit credit plans, one for fractional accrual plans (including flat benefit plans), and one for insurance contract plans.¹¹⁷

Target Plan Benefits

Because target-benefit plans are defined-contribution plans that determine allocations based on a defined-benefit funding approach, the safe harbor is included in the rules for cross-testing.

401(k) Plans

Special nondiscrimination tests and design-based safe harbors apply in the case of contributions to 401(k) and 401(m) plans.¹¹⁸

Aggregation and Restructuring

Under certain circumstances, a plan may be aggregated (combined) with other plans or restructured (treated as two or more separate plans) for purposes of meeting the nondiscrimination in amount requirement.¹¹⁹ If two or more plans are permissively aggregated and treated as constituting a single plan for purposes of satisfying the minimum coverage requirements, the aggregated plans must also be treated as a single plan for purposes of meeting the nondiscrimination requirements.¹²⁰ The regulations include guidelines for determining whether several such plans, when considered as a unit, provide contributions and benefits that discriminate in favor of HCEs.

Integrated Plans

An integrated defined-benefit plan will not be considered discriminatory merely because the plan is integrated with Social Security (i.e., the plan uses the permitted disparity rules). A number of the safe-harbor defined-benefit plan designs provided in the nondiscrimination regulations allow permitted

¹¹⁶ Treas. Reg. Section 1.401(a)(4)-2(c)(1).

¹¹⁷ Treas. Reg. Section 1.401(a)(4)-3(b).

¹¹⁸ IRC Sections 401(k), 401(m); Treas. Reg. Section 1.401(a)(4)-1(b)(2)(ii)(B).

¹¹⁹ Treas. Reg. Section 1.401(a)(4)-9(c).

¹²⁰ Treas. Reg. Section 1.401(a)(4)-9(a).

disparity to be used; however, a defined-contribution plan must pass the general test in order to use permitted disparity.

Cross-Testing

The most common form of cross-testing is *new comparability* testing of profit-sharing plans. The new comparability feature uses cross-testing to show that contributions under the plan provide nondiscriminatory benefits. Cross-testing can also involve aggregating a defined-benefit plan with a defined-contribution plan, and testing the plans together on the basis of the benefits they provide. Final regulations that took effect January 1, 2002, established three testing alternatives under which a cross-tested defined-contribution plan can satisfy the nondiscrimination in amount requirement, as well as rules for testing the combination of a defined-benefit plan and a defined-contribution plan on a benefits basis. The three methods are:

1. *Minimum allocation gateway.* The minimum allocation gateway test sets forth two standards for new comparability plans. First, if the allocation rate for each NHCE in the plan is at least one-third of the allocation rate of the HCE with the highest allocation rate under the plan, the gateway will be satisfied. In the alternative, if the allocation rate for each NHCE is at least 5 percent of his or her compensation, the gateway will be satisfied. The gateway is deemed satisfied if each NHCE receives an allocation of at least 5 percent of the NHCE's compensation, based on the plan year compensation.¹²¹
2. *Broadly available allocation rates.* A new comparability plan need not satisfy the minimum allocation gateway if it provides for *broadly available allocation rates*. To be broadly available, each allocation rate must be currently available to a group of employees that satisfies the IRC Section 410 coverage rules, without regard to the average-benefits percentage test.¹²² The final regulations allow groups receiving two different allocation rates to be aggregated for purposes of determining whether allocation rates are "broadly available." For example, a group receiving a 3-percent allocation rate could be aggregated with a group receiving a 10-percent allocation rate if each group passes the coverage test (not counting the average-benefits percentage test).¹²³
3. *Age-based allocation rates.* A plan that provides for age-based allocation rates will also be excepted from the minimum allocation gateway if it has a "gradual age or service schedule." A plan has a gradual age or service schedule if the allocation formula for all employees under the plan provides for a single schedule of allocation rates that (a) defines a series of bands based solely on age, years of service or points

¹²¹ Treas. Reg. Section 1.401(a)(4)-8(b)(1)(vi)(A) and (B).

¹²² Treas. Reg. Section 1.401(a)(4)-8(b)(1)(iii)(A).

¹²³ Rev. Rul. 2001-30 (2001-1 CB 46); Treas. Reg. § 1.401(a)(4)-8(b)(1)(vii), permitted disparity (integration) may be disregarded.

representing the sum of the two, which applies to all employees whose age, years of service, or points are within each band, and (b) the allocation rates under the schedule increase smoothly at regular intervals (as defined in the regulations). Sample schedules of smoothly increasing allocation schedules, based on the sum of age and service, are included in the final regulations.¹²⁴

Permitted Disparity (Integration)

Permitted disparity is not permitted with respect to (1) ESOPs, (2) elective contributions under a qualified cash or deferred arrangement, or employee or matching contributions as defined in IRC Sections 401(k) and 401(m).¹²⁵

Defined-Contribution Plans

Integration under a defined-contribution plan is more fully discussed in Chapter 7, “Permitted Disparity—Integration of Contributions.”

Defined-Benefit Plans

A defined-benefit plan will not be considered discriminatory merely because the plan provides that a participant’s retirement benefit may not exceed the excess of (1) the participant’s final pay with the employer, over (2) the retirement benefit, under Social Security law, derived from employer contributions attributable to service by the participant with the employer.¹²⁶

Overall Permitted Disparity

The Code specifies that in the case of an employee covered by two or more plans of an employer, regulations are to provide rules preventing the multiple use of the disparity otherwise permitted. The regulations provide both an annual overall limit and a cumulative overall limit. The annual overall permitted disparity limit requires the determination of a fraction based on the disparity provided to an employee for the plan year under each plan. The annual overall limit is met if the sum of those fractions does not exceed one.¹²⁷ The cumulative permitted disparity limit is generally satisfied if the total of an employee’s annual disparity fractions under all plans for all years of service does not exceed 35.¹²⁸

Vesting and Nonforfeitability

At this point, the contributions have been made or benefits have been earned and the employee is entitled under the terms of the plan to a distribution of his or her accrued benefit, but only to the extent that the accrued benefit is vested and nonforfeitable under the plans provision. There is a distinction be-

¹²⁴ Treas. Reg. Section 1.401(a)(4)-8(b)(1)(iv)(A).

¹²⁵ Treas. Reg. Section 1.401(l)-1(a)(4).

¹²⁶ IRC Section 401(a)(5)(D)(i); Treas. Reg. Section 1.401(a)(5)-1(d)(2).

¹²⁷ Treas. Reg. Section 1.401(l)-5, 1.401(l)-5(b)(1).

¹²⁸ Treas. Regs. Section 1.401(l)-5(c)(1)(i), 1.401(l)-5(c)(2).

tween a vested benefit and a nonforfeitable benefit. A participant is *vested* if he or she has an immediate, fixed right of present or future enjoyment to his or her accrued benefit. However, a plan with a generous (short) vesting schedule may contain a forfeiture provision that applied, for example, to a participant who quits and goes to work for a competitor of the employer in the area or commits a crime against the employer.¹²⁹ A right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right.¹³⁰

A qualified plan is not required to provide a preretirement death benefit, aside from the employee's accrued benefit derived from the employee's own contributions. "A right to an accrued benefit derived from employer contributions shall not be treated as forfeitable solely because the plan provides that it is not payable if the participant dies . . ." except in the case of a survivor annuity if the plan provides for early retirement as required by the joint and survivor annuity provisions.¹³¹ Thus, a plan that does not have an option for an annuity-type payout could provide that no employer-derived benefit is payable if death occurs before the normal retirement age specified in the plan. This could affect the owner, too.

Example. A corporation plan provides that an employee is fully vested in his or her employer-derived accrued benefit after completion of three years of service. The plan also provides that if the employee works for a competitor all of his or her rights in the plan are forfeited. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under IRC Section 411 and, therefore, the plan would not satisfy the requirements of that section. If the plan limited the forfeiture to employees who completed less than five years of service, the plan would not fail to satisfy the requirements of IRC Section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under IRC Section 411(a)(2)(A).¹³²

A plan must meet the following minimum standards concerning the nonforfeitability of benefits (vesting).¹³³

- An employee's right to a normal retirement benefit must be nonforfeitable upon the attainment of normal retirement age.¹³⁴ *Normal retirement age* means the earlier of (1) normal retirement age under the plan, or (2) the later of age 65 or the fifth anniversary of the date participation commenced.¹³⁵ The *normal retirement benefit* is the em-

¹²⁹ Rev. Rul. 85-31 (1985-1 CB 153); *Clark v. Lauren Young Tire Center Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987); *Noell v. American Design, Inc.*, 764 F.2d 827 (11th Cir. 1985); See, too, Temp. Treas. Reg. Section 1.411(a)-4T.

¹³⁰ Temp. Treas. Reg. Section 1.411(a)-4T(a).

¹³¹ IRC Sections 401(a)(11), 411(a)(3)(A), 417(c).

¹³² Temp. Treas. Reg. Section 1.411(a)-4T, ex 1.

¹³³ IRC Section 401(a)(7).

¹³⁴ IRC Section 411(a).

¹³⁵ IRC Section 411(a)(8).

employee's accrued benefit without regard to whether it is vested. Thus, a plan cannot qualify if it provides no retirement benefits for employees with less than five years of vesting service before the normal retirement age.¹³⁶

- If an employee's allocations (or benefit accruals in the case of a defined-benefit plan) cease, or if the rate of an employee's rate of allocation or benefit accrual, as applicable, is reduced because of the attainment of any age, the plan will not satisfy the IRC Section 411 minimum vesting standards.¹³⁷
- An employee's rights in his or her accrued benefit derived from their own contributions must be nonforfeitable at all times.¹³⁸
- If the present value of an employee's vested accrued benefit exceeds \$5,000, the benefit may not be immediately distributed without the consent of the participant, according to IRC Section 411(a)(11)(A). For purposes of the \$5,000 limit, the vested accrued benefit may be determined without regard to rollover contributions and earnings allocable to them.¹³⁹
- An employee must be granted a nonforfeitable rights to his or her accrued benefits derived from employer contributions in accordance with one of the vesting schedules described in the following subsections:

Five-Year Cliff Vesting

An employee who has at least five years of service must generally have a nonforfeitable right to 100 percent of his or her accrued benefit.¹⁴⁰ In the case of matching contributions, a three-year cliff vesting requirement (100 percent after three years of service) must be satisfied.¹⁴¹

Three- to Seven-Year Vesting

An employee who has completed at least three years of service must have a nonforfeitable right to not less than the following percentages of his or her accrued benefit:¹⁴²

¹³⁶ Rev. Ruls. 84-69 (1984-1 CB 125), 81-211 (1981-2 CB 98).

¹³⁷ IRC Section 411(b)(1)(H), 411(b)(2).

¹³⁸ IRC Section 411(a)(1); see, Rev. Rul. 76-47 (1976-1 CB 109), 78-202 (1978-1 CB 124) as amplified by Rev. Rul. 89-60 (1989-1 CB 113) regarding mandatory employee contributions.

¹³⁹ IRC Section 411(a)(11)(D).

¹⁴⁰ IRC Section 411(a)(2)(A); Temp. Treas. Reg. Section 1.411(a)-3T(b).

¹⁴¹ IRC Sections 401(m)(4)(A), 411(a)(12)(A).

¹⁴² IRC Section 411(a)(2)(B); Temp. Treas. Reg. Section 1.411(a)-3T(c).

Years of Service	Minimum Vesting (Percent)
3	20%
4	40%
5	60%
6	80%
7 or more	100%

Under this method, matching contributions must vest over a two-to-six-year period, as follows:¹⁴³

Years of Service	Minimum Vesting (Percent)
2	20%
3	40%
4	60%
5	80%
6 or more	100%

The term *year of service* generally means a 12-month period designated by the plan during which the employee has worked at least 1,000 hours.¹⁴⁴ All years of an employee's service with the employer are taken into account for purposes of computing nonforfeitable percentages, except those years specifically allowed to be excluded.¹⁴⁵ If a plan's vesting schedule is modified by a plan amendment, each participant with at least three years of service must be permitted to elect to have his nonforfeitable percentage computed under the plan without regard to the amendment and without regard to the exceptions set forth in IRC Section 411(a)(4).¹⁴⁶

In computing the period of service under the plan for purposes of determining the nonforfeitable percentage, all of an employee's years of service with the employer or employers maintaining the plan must be taken into account, except that the following years of service may be disregarded:¹⁴⁷

1. Before age 18
2. During a period for which the employee declined to contribute to a plan requiring employee contributions

¹⁴³ IRC Section 411(a)(12)(B).

¹⁴⁴ IRC Section 411(a)(5).

¹⁴⁵ Treas. Regs. Sections 1.411(a)-5, 1.411(a)-6.

¹⁴⁶ IRC Section 411(a)(10); see, too, Temp. Treas. Reg. Section 1.411(a)-8T(b), 1.411(a)-8T(b)(3).

¹⁴⁷ IRC Section 411(a)(4).

3. With an employer during any period for which the employer did not maintain the plan or a predecessor plan (as defined under regulations prescribed by the Secretary of the Treasury)
4. Breaks in service
5. Before January 1, 1971, unless the employee has had at least three years of service after December 31, 1970
6. In plan years beginning before September 2, 1973, can generally be disregarded provided such service would have been disregarded under the rules of the plan with regard to breaks in service on such date

Suspension Upon Reemployment

A plan may provide that payment of benefits to a retired employee is suspended for any period during which he resumes active employment with the employer who maintains the plan.¹⁴⁸

Pattern of Abuse

If there is a pattern of abuse, which is determined solely on the facts and circumstances in each case, a more rapid rate of vesting may be required.¹⁴⁹

Full Vesting Required on Plan Termination or Discontinuance of Contributions

The plan must provide that upon its termination or partial termination (or, in the case of a profit-sharing plan, also upon complete discontinuance of contributions, other than a temporary suspension), benefits accrued to the date of termination (or date of discontinuance of contributions, other than a temporary suspension) become nonforfeitable to the extent funded at such date.¹⁵⁰ Unless facts suggest a partial termination, the merger or conversion of a money-purchase pension plan into a profit-sharing plan does not result in a partial termination for this purpose, provided the following apply:

1. Employees who are covered by the money-purchase plan remain covered under the ongoing profit-sharing plan.
2. The assets and liabilities in the money-purchase plan retain their characterization under the profit-sharing plan.
3. The employees vest in the profit-sharing plan under the same vesting schedule that existed under the money-purchase plan.¹⁵¹

¹⁴⁸ DOL Reg. Section 2530.203-3; Rev. Rul. 81-140 (1981-1 CB 180); Notice 82-23 (1982-2 CB 752).

¹⁴⁹ ERISA Conf. Comm. Report, 1974-3 CB 437; Prop. Treas. Reg. Section 1.411(d)-1.

¹⁵⁰ IRC Section 411(d)(3).

¹⁵¹ Rev. Rul. 2002-42 (2002-2 CB 76).

Deductions

One of the primary tax advantages of a qualified retirement plan is that a current deduction is allowed for the company's contributions to a plan that provides future benefits. To be deductible, the contribution must be an *ordinary and necessary* expense and must be compensation for services actually rendered. Also, the contribution, when considered together with the employee's regular compensation, must be *reasonable in amount* for the services rendered. What constitutes reasonable compensation depends upon the facts and circumstances of each particular case.¹⁵²

A contribution on behalf of a self-employed individual satisfies the ordinary-and-necessary business expense requirement if it does not exceed the individual's earned income for the year determined without regard to the deduction for the contribution.¹⁵³

Tax-deductible contributions to a qualified retirement plan may be made at any time during the taxable year and even after the end of the taxable year up to the due date (including valid extensions) for the filing of the employer's federal income tax return for the particular year. Timely contributions made after the end of the taxable year are deductible for that taxable year if either (1) the employer designates in writing to the plan administrator or trustee that the contribution is for the preceding year, or (2) the employer claims the contribution as a deduction on its tax return for the preceding year. The designation, once made, is irrevocable.¹⁵⁴ A contribution is timely if it is made before the income tax return extended due date even if it is made after the return is filed. An employer must obtain a valid extension to file the return in order to extend the time to make a contribution. An application for an extension of time to file is invalid if the employer fails to comply with all requirements of the regulations.¹⁵⁵

The employer's timely mailing of the contribution is adequate. Thus, a contribution mailed and bearing a postage cancellation date no later than the due date of the employer's tax return, including extensions, is timely even if the trust received it after such due date.¹⁵⁶

Coordination With Minimum Funding Rules

Tax-deductible plan contributions may be made after the end of the taxable year if payment is made by the due date (including extensions) for filing the employer's federal income tax return for that taxable year. For purposes of the minimum funding standards, contributions made after the end of the plan year may relate back to that year if they are made within eight and one-half months after the end of the plan year. Thus, contributions made after the due

¹⁵² IRC Sections 162, 404; Treas. Reg. Section 1.404(a)-1(b); IRS Ann 98-1 (1998-1 CB 282).

¹⁵³ IRC Section 404(a)(8); Temp. Treas. Reg. Section 1.404(a)(8)-1T; but see *Gale v. United States*, 768 F Supp 1305 (ND IL 1991).

¹⁵⁴ IRC Section 404(a)(6); Rev. Rul. 76-28 (1976-1 CB 106); Ltr. Rul. 199935062 (Mar 10, 1999).

¹⁵⁵ Rev. Rul. 66-144 (1966-1 CB 91); IRC Section 6081(b); Treas. Reg. Section 1.6081-3.

¹⁵⁶ Ltr. Rul. 8536085 (Jun. 14, 1985).

date of the return may satisfy the minimum funding rules under IRC Section 412, but may not be deductible until later years.

Carryforward

Although nondeductible contributions (other than amounts needed to satisfy minimum funding standards) may be subject to a 10-percent excise tax until corrected, such amounts may normally be carried forward.¹⁵⁷

¹⁵⁷ IRC Section 404(a)(3)(A)(ii).

Chapter 7

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Permitted Disparity—Integration of Contributions

Permitted disparity can reduce an employer's retirement plan contribution expense. Permitted disparity permits an employer that establishes a retirement plan to coordinate payments it makes into the Social Security retirement system for plan purposes. In theory, the integration rules avoid a duplication of benefits by not requiring that contributions be made twice on the same compensation. That is, in an integrated plan, contributions will favor higher paid employees: employees who earn above a certain amount will receive a percentage of the contributions that is higher than their pro rata share of the compensation paid to all participants. A defined-benefit plan may also allow for permitted disparity. This chapter discusses the types of plans that may allow for permitted disparity (integration) and how it affects plan design. Spreadsheet or software programs are generally used to design integrated plans, especially when self-employed individuals are participants.¹

Plan Types

Both defined-contribution plans and defined-benefit plans can provide for permitted disparity.²

Defined-Contribution Plans

A defined-contribution excess plan is a defined-contribution plan under which the rate at which employer contributions (and forfeitures) are allocated to the accounts of participants with respect to compensation above a level specified in the plan (expressed as a percentage of such compensation) is greater than

¹ See, for example, QP-SEP Illustrator Software at <http://www.benefitslink.com/gsl>.

² IRC Sections 401(a)(5)(C) and (D), 401(l); Treas. Reg. Section 1.401(l)-1.

the rate at which employer contributions (and forfeitures) are allocated with respect to compensation at or below such specified level (expressed as a percentage of such compensation).³

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is a defined-contribution plan and may allow for permitted disparity.⁴ Under a special rule only applicable to a SEP, the exclusion of contributions from a participant's income is subject to the \$41,000 (for 2004, plus catch-up contribution) limit under Internal Revenue Code (IRC or the Code) Section 415. However, if a SEP provides for permitted disparity the \$41,000 limit is reduced for certain individuals. (See the detailed discussion in the section entitled "Defined-Contribution Plan Integration," below).

Defined-Benefit Excess Plans

A defined-benefit excess plan is a defined-benefit plan under which the rate at which employer-provided benefits are determined with respect to average annual compensation above a level specified in the plan (expressed as a percentage of such compensation) is greater than the rate with respect to compensation at or below such specified level (expressed as a percentage of such compensation).⁵

Defined-Benefit Offset Plans

A defined-benefit offset plan is a defined-benefit plan that is not a defined-benefit excess plan and that provides that each participant's employer-provided benefit is reduced by a specified percentage of the participant's final average compensation up to the offset level under the plan.⁶

Target-Benefit Plans

Target-benefit plans are generally treated like defined-benefit plans for purposes of the permitted disparity rules.⁷

Defined-Contribution Plan Integration

Definitions Relating to Permitted Disparity

- *Base-contribution percentage.* The base-contribution percentage (BCP) is the percentage of compensation at which employer contributions (and forfeitures) are allocated to the accounts of participants with re-

³ Treas. Reg. Section 1.401(l)-1(c)(16)(ii).

⁴ IRC Section 408(k)(3)(D), 414(j).

⁵ Treas. Reg. Section 1.401(l)-1(c)(16)(i).

⁶ Treas. Reg. Section 1.401(l)-1(c)(25).

⁷ Treas. Reg. Section 1.401(l)-2(a)(1).

spect to the compensation of participants at or below the integration level specified in the defined-contribution plan for the plan year.⁸

- *Excess-contribution percentage.* The excess-contribution percentage (ECP) is the percentage of compensation at which employer contributions (and forfeitures) are allocated to the accounts of participants with respect to the compensation of participants above the integration level specified in the defined-contribution plan for the plan year.⁹
- *Integration level.* The integration level is the amount of compensation specified in the defined-contribution or defined-benefit excess plan at or below which the rate of contributions or benefits provided under the plan is less than the rate with respect to compensation above such level.¹⁰ The integration level may not exceed the taxable wage base (TWB) amount in effect on the first day of the plan year.
- *Spread (or disparity rate).* The spread, or disparity rate, is the difference between the excess and base-contribution percentages.
- *Taxable wage base.* The TWB is the maximum amount of earnings in any calendar year that may be considered wages for Social Security purposes. For 2004, this amount is \$87,900.
- *Compensation.* Compensation means compensation as defined under the plan provided that such definition is nondiscriminatory and satisfies IRC Section 414(s). An employer may elect not to include as compensation elective deferrals.¹¹

Maximum Spread or Disparity Rate

The excess-contribution percentage (the rate of contributions made to the plan by the employer with respect to compensation above the integration level, expressed as a percentage of such compensation) may not exceed the base-contribution percentage (the rate of contributions made to the plan by the employer with respect to compensation at or below the integration level, expressed as a percentage of such compensation) by more than the lesser of the following:

1. The base-contribution percentage, or
2. The greater of:
 - a. 5.7 percent, or
 - b. The percentage equal to the rate of tax attributable to the old-age insurance portion of the Old-Age, Survivors, and Disability Insurance (OASDI) as of the beginning of the plan year.¹²

⁸ IRC Section 401(l)(2)(B)(ii); Treas. Reg. Section 1.401(l)-1(c)(4).

⁹ IRC Section 401(l)(2)(B)(i); Treas. Reg. Section 1.401(l)-1(c)(15).

¹⁰ IRC Section 401(l)(5)(A)(i); Treas. Reg. Section 1.401(l)-1(c)(20).

¹¹ IRC Sections 401(l)(5)(B), 414(s).

¹² IRC Sections 401(l)(2)(A), 3111(a) (for 1990 or thereafter, the rate is 6.2%); Notice 89-70 (1989-1 CB 730).

Note. Social Security's OASDI program limits the amount of earnings subject to taxation for a given year. The same annual limit also applies when those earnings are used in a benefit computation. A chart of the OASDI rates for all years is available at <http://www.ssa.gov/OACT/COLA/CBB.html>.

The 5.7-percent factor must be reduced under certain circumstances.

In light of the foregoing, the following, for example, would be true:

- A contribution formula of 10 percent below and 20 percent above a specified dollar level would violate the "lesser of" rules.
- A contribution formula of 2 percent below and 4 percent above a specified dollar level would be permitted, but the plan might be top heavy.
- A contribution formula of 3 percent below and 6 percent above a specified dollar level would be permitted.
- A contribution formula of 6 percent below and 12 percent above a specified dollar level would violate the 5.7-percent rule.

Reduction of Maximum 5.7-Percent Spread (or Disparity Rate)

The maximum spread, or disparity rate, of 5.7 percent depends on the integration level selected for the plan year. A rate of 5.7 percent may be used when the plan is integrated at the TWB or the integration level is set at 20 percent or less of the TWB. If, however, the integration level is set above 20 percent of the TWB¹³ and below the TWB, the maximum spread factor of 5.7 percent must be reduced in accordance with the following rules:

If the Integration Level Is More Than	But Not More Than	The 5.7-Percent Maximum Disparity Rate Is Reduced to:
The greater of \$10,000 or 20% of the TWB	80% of the TWB	4.3%
80% of the TWB	An amount less than 100% of the TWB	5.4%

Based on the 2004 TWB of \$87,900, the maximum 5.7-percent spread would be reduced as follows:

If the Integration Level Is More Than	But Not More Than	The 5.7-Percent Maximum Disparity Rate:
\$0	\$17,580	Remains at 5.7%
\$17,580	\$70,320	Is reduced to 4.3%
\$70,321	\$87,899	Is reduced to 5.4%
N/A	\$87,900	Remains at 5.7%

¹³ Or \$10,000, if 20 percent of the TWB is less than \$10,000. See Treas. Reg. Section 1.401(l)-2(d)(4).

Defined-Contribution Plan Uniform Disparity Rule

The EPC must exceed the base-contribution percentage by an amount that is uniform for all participants.¹⁴ There is, however, an exception for special employees (other than self-employed individuals) who are not subject to Federal Insurance Contributions Act (FICA) taxes, i.e., employees for whom the employer makes no Social Security contributions. For each employee under an integrated SEP for whom no tax under IRC Sections 3111(a), 3221, or 1401 is required to be paid, employer contributions must be allocated to the account of the employee with respect to the employee's total plan-year compensation at the excess-contribution percentage rate. That is, if the employer does not pay employment, railroad retirement, or self-employment taxes on behalf of an eligible employee, contributions must be allocated to the account of the employee at the excess-contribution percentage rate.¹⁵

Example. An integrated plan formula provides for a contribution of 2 percent of compensation up to \$10,000 and 4 percent of compensation in excess of \$10,000. The plan is not top heavy. For all employees, the contribution rate for compensation above the integration level is 4 percent and the contribution rate for compensation at or below the integration level is 2 percent. The ECP therefore exceeds the base-contribution percentage by an amount that is uniform for all participants.

Example. Fern owns and operates a successful business, Fernway, Inc., and employs her 17-year-old son Tommy on a full-time basis. Tommy earns \$30,000. Because Tommy is under the age of 18 and is in the employ of his parent, his income is not subject to employment taxes.¹⁶ Fernway maintains an integrated profit-sharing plan, and this year it will contribute 5.7 percent of compensation up to \$17,400 and 11.4 percent of compensation that is in excess of \$17,000. The contribution for Tommy will not be integrated. He will receive \$3,420 ($\$30,000 \times .114$) because Fernway is not subject to employment taxes on Tommy's wages.

Practice Pointer: In general, the maximum period for which contributions may be integrated with Social Security contributions is 35 integration years (cumulative permitted disparity years) per employee. Presumably, contributions must also be allocated to the account of a non-FICA employee at the ECP in the unlikely event that the employee's cumulative permitted disparity years exceed 35.¹⁷

¹⁴ Treas. Reg. Section 1.401(l)-2(c).

¹⁵ Treas. Reg. Section 1.401(l)-2(c)(2)(iii).

¹⁶ IRC Section 3121(b)(3)(A).

¹⁷ See IRC Sections 408(k)(3)(D), 1402(c), 1402(e), 3121(b); Treas. Reg. Section 1.401(l)-5(a)(3)-1.401(l)-5(a)(5), 1.401(l)-5(c)(1)(i), and 1.401(l)-5(c)(1)(ii). Integration years, or cumulative permitted disparity years, generally are the number of years credited to a participant for allocation or accrual purposes under an integrated SEP or any integrated qualified plan described in IRC Section 401(a) (whether or not terminated) ever maintained by the employer. For purposes of determining a participant's cumulative permitted disparity limit, all years ending in the same calendar year are treated as the same year. If the participant has not benefited under a defined-benefit or target-benefit plan for any year beginning on or after January 1, 1994, the participant has no cumulative disparity limit, and the rules are deemed satisfied.

Top-Heavy Contributions and the Uniformity Rule

A contribution that is made under the top-heavy rules is required to be made to non-key employees. Because the contribution is required under the top-heavy rules, the introduction of a third percentage does not violate the uniformity rule for an integrated plan. Introduction of a third percentage, relative to the integration level, can occur if the base-contribution percentage is less than 3 percent and the plan is top heavy. In such a case, the minimum required top-heavy contribution may be made to some but not necessarily all employees with compensation at or below the plan's integration level.

Allocating Integrated Contributions

Using the basic rules set forth above, contributions are made to employees in accordance with the formula contained in the plan. Alternatively, when the *amount* to be contributed is known, the contribution can be allocated in four steps. Note, the four-step method will result in the same allocation to employees as the percentage method (previously discussed), provided the BCP is at least 3 percent. Unless the employer also maintains a defined-benefit plan, this method will also satisfy all top-heavy rules.

- *Step 1.* Contributions will be allocated to each participant's account in the ratio that each participant's total compensation bears to *all* participant's total compensation, *but not* in excess of 3 percent of each participant's compensation.
- *Step 2.* Any contributions remaining after the allocation in Step 1 will be allocated to each participant's account in the ratio that each participant's compensation for the plan year in *excess* of the integration level bears to the *excess* compensation of all participants, *but not* in excess of 3 percent.
- *Step 3.* Any contributions remaining after the allocation in Step 2 will be allocated to each participant's account in the ratio that the *sum* of each participant's *total* compensation plus compensation in *excess* of the integration level bears to the sum of all participants' total compensation and compensation in excess of the integration level, *but not* in excess of the maximum disparity rate shown below:

For 2004 if the Integration Level Is More Than	But Not More Than	Then the Maximum 2004 Disparity Limit Is Reduced to:
\$0	\$17,580	Remains at 2.7%
\$17,580 (20% of TWB)	\$70,320	1.3%
\$70,321 (80% of TWB + \$1)	\$87,899	2.4%
TWB	\$87,900	Remains at 2.7%

- *Step 4.* Any remaining employer contributions will be allocated to each participant's account in the ratio that each participant's total compensation for the plan year bears to all participants' total compensation for that year.

Under the four-step method, a formula contribution of 2 percent of compensation up to the plan's integration level, plus 4 percent of compensation in excess of the integration level, would not be possible.

Example. Assume a profit-sharing or money purchase pension plan is integrated at \$10,000; assume further that the contribution amount is \$10,025.

Wages	Step 1	Step 2	Step 3	Step 4	Totals (Steps 1 to 4)
\$10,000	\$300	\$0	$\$10,000 \div$ $\$120,000^* \times$ $\$6,425 =$ $\$270$ (2.7% max. applied)	$\$10,000 \div$ $\$70,000 \times$ $\$3,185 =$ $\$455$	\$1,025
\$60,000	\$1,800	\$1,500 (excess comp. of $\$50,000 \times$ 3%)	$\$60,000 +$ $\$50,000 =$ $\$110,000 \div$ $\$120,000 \times$ $\$6,425 =$ $\$2,970$ (2.7% max. applied)	$\$60,000 \div$ $\$70,000 \times$ $\$3,185 =$ $\$2,730$	\$9,000
To be allocated is \$10,025	Remaining contribution is \$7,925	Remaining contribution is \$6,425	Remaining contribution is \$3,185	Remaining contribution is \$0	Total allocated is \$10,025

* \$120,000 = total compensation of \$10,000 + \$60,000, plus excess compensation of \$50,000.

Selecting an Integration Level

Use careful analysis and educated guesswork in selecting the appropriate integration level and spread. Consider the following general rules of thumb:

- Set the integration level at the amount of compensation paid to the highest paid employee that the employer does not wish to favor, but not more than the TWB in effect at the beginning of the plan year.
- For 2004, always try \$87,900, \$70,321 (80 percent of the TWB + \$1), \$17,580 (20 percent of the TWB), and \$1.
- Owners with slightly higher compensation than employees should consider using a 5.7-percent spread at the \$17,580 (or less) level.

- Nonowners will not always fall into convenient bands. At any given contribution amount, aggregate contributions and the effectiveness percentage for the group of employees being favored will fluctuate as the combination of integration level and spread are applied. Try several approaches.

Example. The Darn Knot Shop, Inc. maintains an integrated profit-sharing plan. Lorenzo Darn wants to receive the maximum permitted contribution amount for 2004 of \$41,000 at the lowest overall cost to the employer. For comparative purposes, the plan is illustrated at several different integration levels. The compensation and contribution amounts are shown below. The plan with the least cost would be designed with an integration level of \$70,321 (80% of the TWB, plus \$1).¹⁸

		Integration Level and Spread					
		\$0	\$1	\$17,580	\$70,320	\$70,321	\$87,900
		Not Integrated	5.7% Spread	5.7% Spread	4.3% Spread	5.4% Spread	5.7% Spread
Participant	Compensation	Allocated Contribution					
L. Darn	\$165,000	\$ 41,000.00	\$ 41,000.00	\$ 41,000.00	\$ 41,000.00	\$ 41,000.00	\$ 41,000.00
A. Darn	100,000	24,848.48	24,848.46	24,453.73	23,657.30	23,352.57	22,874.73
B. Darn	50,000	12,424.24	12,424.20	11,725.84	11,190.53	10,874.95	11,092.51
D. Harp	50,000	12,424.39	12,424.20	11,725.84	11,190.53	10,874.95	11,092.51
C. Knott	40,000	9,939.39	9,939.35	9,180.26	8,952.43	8,699.96	8,874.01
J. Frank	30,000	7,454.54	7,454.50	6,634.68	6,714.32	6,524.97	6,655.51
Total Cost:		\$108,090.89	\$108,090.71	\$104,720.33	\$102,705.11	\$101,327.40	\$101,589.27

Reduction of \$41,000 Limit in an Integrated SEP

Under a SEP, the amount of total contributions that can be excluded from a participant's gross income is subject to a 25 percent of includible compensation or \$41,000 (for 2004) limit. The \$41,000 amount is reduced, however, in the case of a highly compensated employee (HCE) participating on an integrated plan. The reduction amount is equal to the SEP plan's spread percentage (generally 5.7 percent, 5.4 percent, or 4.3 percent) multiplied by the HCE's compensation not in excess of the plan's integration level or the TWB, whichever is less.¹⁹ Compensation in excess of \$205,000 (the 2004 limit) is not considered.

¹⁸ All computations performed using QP-SEP Illustrator Software. See <http://www.benefitslink.com/gsl> for more information.

¹⁹ IRC Section 402(h)(2)(B).

For 2004, the maximum offset produces a limit of \$35,989.70, which is \$41,000 less the product of the maximum integration level of \$87,900 multiplied by .057, multiplied by \$37,989.70. with catchup contributions under a salary-reduction or elective SEP (SARSEP) if age 50 or older. See following chart for examples of typical maximum limits for 2004.

Plan Integration Level	Percent of TWB	Max Spread	Adjusted \$41,000 Limit
\$87,900	100%	5.7%	\$35,989.70
\$70,321	80% + \$1	5.4	\$37,202.66
\$30,000	34.129693%	4.3	\$39,710.00
\$17,400	20%	5.7	\$40,008.20
\$ 1	.000011377	5.7	\$40,994.30

Note. Only an NHCE can receive an allocation of \$41,000 in an integrated SEP.

The reduction (offset) does not apply to qualified plans. A qualified defined-contribution plan may generally provide an HCE with an integrated contribution allocation of up to \$41,000. It should also be noted that catch-up contributions under a SARSEP are not affected by the \$41,000 or \$41,000 (reduced in the case of a SARSEP) limit and may be made in addition to the maximum allocation amounts described above.

Multiple Integrated Plans

An employer may have more than one integrated plan, although the rules can be somewhat unwieldy. It should be noted, however, that the extent of integration may not exceed 100 percent for any year. For example, an employer contributing 6 percent of total compensation may not also provide for a 5.7-percent contribution on compensation in excess of the TWB in two separate plans; however, a contribution of 2.85 percent on compensation in excess of the TWB in two separate plans would be permitted.

Defined-Benefit Plan Integration

Defined-Benefit Excess Plans

A defined-benefit excess plan will meet the permitted disparity rules if the EBP does not exceed the base-benefit percentage (BBP) by more than the maximum excess allowance. For purposes of the permitted disparity rules,

target benefit plans are generally treated like a defined-benefit plan.²⁰ Benefits must be based on average annual compensation.

Furthermore, any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided with respect to compensation above the integration level must also be provided with respect to compensation below the integration level. Thus, for example, if a lump-sum distribution option, calculated using particular actuarial assumptions, is available for benefits relating to compensation above the integration level, the same lump-sum option must be available on an equivalent basis for benefits based on compensation up to the integration level.²¹

Definitions Relating to Permitted Disparity

- *Excess-benefit percentage.* The excess-benefit percentage (EBP) is the percentage of compensation at which employer-provided benefits are determined with respect to average annual compensation of participants above the integration level specified in the defined-benefit plan for the plan year.²²
- *Base-benefit percentage.* The BBP is the percentage of compensation at which employer-provided benefits are determined with respect to average annual compensation of participants at or below the integration level specified in the defined-benefit plan for the plan year.²³
- *Maximum excess allowance.* The maximum excess allowance (MEA) for a plan year is the lesser of either the BBP or .75 percentage point.²⁴
- *Compensation.* Compensation means compensation as defined under the plan provided that such definition is nondiscriminatory and satisfies IRC Section 414(s). An employer may elect not to include as compensation elective deferrals.²⁵
- *Final average compensation.* Final average compensation means the average of the participant's annual compensation for (1) the three-consecutive-year period ending with or within the plan year or (2) if shorter, the participant's full period of service; but it does not include compensation for any year in excess of the TWB in effect at the beginning of such year.²⁶
- *Covered compensation.* Covered compensation means the average (without indexing) of the TWBs for the 35 calendar years ending with the year an individual attains Social Security retirement age (SSRA). A defined-benefit plan can provide for permitted disparity on the basis

²⁰ Treas. Reg. Section 1.401(l)-2(a)(1).

²¹ IRC Section 401(l)(3); Treas. Reg. Section 1.401(l)-3.

²² IRC Section 401(l)(3)(A); Treas. Reg. Section 1.401(l)-1(c)(14).

²³ IRC Section 401(l)(3)(A); Treas. Reg. Section 1.401(l)-1(c)(3).

²⁴ IRC Section 401(l)(4)(A); Treas. Reg. Section 1.401(l)-3(b)(2).

²⁵ IRC Sections 401(l)(5)(B), 414(s); Treas. Reg. Sections 1.401(l)-1(c)(2), 1.401(l)-1(c)(17).

²⁶ 26 IRC Section 401(l)(5)(D); Treas. Reg. Section 1.401(l)-1(c)(17).

of each individual employee's covered compensation. Covered compensation does not refer to the amount of compensation that the employee actually earned, but reflects the ceiling for TWBs over the years. Covered compensation tables are provided at the end of this chapter.

- *Social Security retirement age (SSRA)*. SSRA means the age used as the retirement age under the Social Security Act and depends on the calendar year of birth, as follows:²⁷

Year of Birth	SSRA
Before 1938	65
After 1937 but before 1955	66
After 1954	67

Although the SSRA is no longer used for purposes of calculating adjustments to the dollar limitation on benefits payable under a defined-benefit plan for limitation years ending after 2001,²⁸ it is still relevant for purposes of calculating certain adjustments with respect to formulas in defined-benefit plans using permitted disparity. (See the subsequent section entitled “Defined-Benefit Plan Uniform Disparity Rule.”)

Example. Fern Corporation maintains a defined-benefit excess plan. The formula is .7 percent of the participant's average annual compensation up to covered compensation for the plan year plus 1.5 percent of the participant's average annual compensation for the plan year in excess of the participant's covered compensation for the plan year, multiplied by the participant's years of credited service with the Fern up to a maximum of 35 years. The plan formula provides a benefit that exceeds the MEA because the EBP, 1.5 percent, for the plan year exceeds the BBP, .7 percent, for the plan year by more than the BBP ($1.5\% - 0.7\% = 0.8\%$ which is more than the BBB of .7%).²⁹

Example. Same facts as in the previous example, except the BBP is .75 percent. Fern's plan would meet the permitted disparity rules because the EBP (1.5 percent) would not exceed the BBP (.75 percent) by more than the MEA (.75 percentage point).

Example. Heather Corporation maintains a defined-benefit excess plan. The formula is 1 percent of average annual compensation up to the integration level for each year of service plus 2 percent of average annual compensation in excess of integration level for each of the first ten years of service plus 1.75 percent of average annual compensation in excess of the integration level

²⁷ Social Security Act Section 216(1); IRC Section 415(b)(8).

²⁸ IRC Sections 415(b)(2)(C) (as amended by EGTRRA 2001 Section 611(a)(2)), 415(b)(2)(D) (as amended by EGTRRA 2001 Section 611(a)(3)); EGTRRA 2001 Section 611(i)(2).

²⁹ Treas. Reg. Section 1.401(l)-3(b)(5).

for each year of service more than ten. The disparity provided under the plan exceeds the MEA because the EBP for each of the first ten years of service (2 percent) exceeds the BBP (1 percent) by more than .75 percent.

Adjustment to the .75 Percentage Point Factor

If benefits commence prior to or after the SSRA, the .75 percentage point factor discussed above is reduced or increased depending on the age at which benefits commence and the participant's SSRA.

The factors in the following table are applicable to benefits that commence in the month the employee attains the specified age. Accordingly, if benefits commence in a month other than the month in which the employee attains the specified age, appropriate adjustments in the .75 percentage point factor in the MEA (discussed previously) must be made. For this purpose, adjustments may be based on straight-line interpolation from the factors in the tables or in accordance with other methods of adjustment specified in the regulations.

Age at Which Benefits Commence	SSRA 67	SSRA 66	SSRA 65
70	1.002	1.101	1.209
69	0.908	0.998	1.096
68	0.825	0.907	0.996
67	0.750	0.824	0.905
66	0.700	0.750	0.824
65	0.650	0.700	0.750
64	0.600	0.650	0.700
63	0.550	0.600	0.650
62	0.500	0.550	0.600
61	0.475	0.500	0.550
60	0.450	0.475	0.500
59	0.425	0.450	0.475
58	0.400	0.425	0.450
57	0.375	0.400	0.425
56	0.344	0.375	0.400
55	0.316	0.344	0.375

Example. The Clock Corporation maintains a defined-benefit excess plan. The plan provides that for an employee with an SSRA of 65, the normal retirement benefit is 1 percent of average annual compensation up to the integration level, plus 1.25 percent of average annual compensation in excess of the integration level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is .25 percent (1.25% – 1.00%). Because this disparity does not exceed the .344 percent factor provided in the table for a benefit payable at age 55 to an employee with an SSRA of 66, Clock’s plan satisfies the requirements with respect to the early retirement benefit. The plan does not use the simplified table.

Since participants will generally have different SSRAs, the following simplified table may be used.³⁰

Age at Which Benefits Commence	Simplified Table
70	1.048
69	0.950
68	0.863
67	0.784
66	0.714
65	0.650
64	0.607
63	0.563
62	0.520
61	0.477
60	0.433
59	0.412
58	0.390
57	0.368
56	0.347
55	0.325

³⁰ Treas. Reg. Section 1.401(l)-3(e).

Excess-Benefit Plan Integration Levels Requirements

For defined-benefit excess plans, the integration level must meet one of the following requirements:³¹

- The integration level for all participants is a single dollar amount that does not exceed the greater of \$10,000 or one-half of the covered compensation of an individual who attains SSRA in the calendar year in which the plan year begins.
- The integration level for all participants is a single dollar amount that is greater than the amount determined above, that does not exceed the TWB, and that satisfies special demographic requirements, and the .75 percent factor is adjusted.
- The integration level for each participant is the participant's covered compensation.
- The integration level for each participant is a uniform percentage (greater than 100 percent) of each participant's covered compensation that does not exceed the TWB in effect for the plan year, and the .75 percent factor is adjusted.
- The integration level for all participants is a single dollar amount (described above), and the .75 percent factor in the MEA is reduced to the lesser of an adjusted factor or 80 percent of the otherwise applicable factor.

Defined-Benefit Offset Plans

A defined-benefit offset plan will meet the permitted disparity rules if the participant's accrued benefit is not reduced by reason of the offset by more than the maximum offset allowance (MOA) and benefits are based on average annual compensation.³²

A defined-benefit plan may offset a participant's benefit by a percentage of the participant's primary insurance amount under Social Security.³³

Maximum Offset Allowance

The maximum offset allowance (MOA) for a plan year is the lesser of the following:

1. .75 percentage point
2. One-half of the gross benefit percentage multiplied by a fraction (not to exceed item 1), the numerator of which is the participant's average

³¹ Treas. Reg. Section 1.401(l)-3(d).

³² IRC Section 401(l)(3)(B); Treas. Reg. Section 1.401(l)-3(b).

³³ Treas. Reg. Section 1.401(l)-3(c)(2)(ix); Notice 92-32 (1992-2 CB 362).

annual compensation and the denominator of which is the participant's final average compensation up to the offset level. (The gross benefit percentage is the percentage of employer-provided benefits, before application of the offset, with respect to a participant's average annual compensation.³⁴)

Example. Doll Corporation maintains a defined-benefit offset plan. The formula provides that, for each year of credited service with the company up to a maximum of 35 years, a participant receives a normal retirement benefit equal to 2 percent of the participant's average annual compensation, reduced by .75 percent of the participant's final average compensation up to covered compensation. The plan meets the permitted disparity rules because the MOA is equal to .75 percent, the lesser of .75 percent or one-half of the gross benefit percentage of 1% ($1/2 \times 2\%$).

Example. Same facts as in the preceding example, except that the normal retirement benefit equal to 1 percent of the participant's average annual compensation, the plan would not meet the permitted disparity rules because the MOA would be equal to .5 percent, the lesser of .75 percent or one-half of the gross benefit percentage of $1/2\%$ ($1/2 \times 1\%$).³⁵

If benefits commence prior to or after SSRA, the .75 percentage point factor is reduced or increased depending on the age at which benefits commence and the participant's SSRA. See tables above for the tables used to adjust the .75 percentage point factor in the MOA.³⁶

Offset Level

The offset level is the dollar limit specified in the defined-benefit offset plan on the amount of each participant's final average compensation taken into account in determining the offset.³⁷

For defined-benefit offset plans, the offset level must meet one of the following requirements:³⁸

- The offset level for all participants is a single dollar amount that does not exceed the greater of \$10,000 or one-half of the covered compensation of an individual who attains SSRA in the calendar year in which the plan year begins.
- The offset level for all participants is a single dollar amount that is greater than the amount determined in above, that does not exceed the participant's final average compensation, and that satisfies special demographic requirements, and the .75 percent factor is adjusted.

³⁴ IRC Section 401(l)(4)(B); Treas. Reg. Sections 1.401(l)-1(c)(18), 1.401(l)-3(b)(3).

³⁵ Treas. Reg. Section 1.401(l)-3(b)(5).

³⁶ Treas. Reg. Section 1.401(l)-3(e).

³⁷ Treas. Reg. Section 1.401(l)-1(c)(23).

³⁸ Treas. Reg. Section 1.401(l)-3(d).

- The offset level for each participant is the participant's covered compensation.
- The offset level for each participant is a uniform percentage (greater than 100 percent) of each participant's covered compensation that does not exceed the participant's final average compensation, and the .75 percent factor is adjusted.
- The offset level for all participants is a single dollar amount (described above), and the .75 percent factor in the MOA is reduced to the lesser of an adjusted factor or 80 percent of the otherwise applicable factor.

Average Annual Compensation

Average annual compensation means the participant's highest average annual compensation for one of the following:

- Any period of at least three consecutive years
- If shorter, the participant's full period of service

For this purpose, a participant's compensation history may begin at any time, but must be continuous, be no shorter than the averaging period, and end in the current plan year.³⁹

Covered Compensation

Covered compensation means the average (without indexing) of the TWBs for the 35 calendar years ending with the year an individual attains SSRA. A defined-benefit plan can provide for permitted disparity on the basis of each individual employee's covered compensation. Covered compensation does not refer to the amount of compensation that the employee actually earned, but reflects the ceiling for Social Security wages, i.e., the TWB, over the years. See, at end of this chapter, the tables in the section entitled "2004 Covered Compensation Tables."

A plan may use an amount of covered compensation for a plan year earlier than the current plan year provided that the earlier plan year is the same for all employees and is not earlier than the plan year that begins five years before the current plan year.

Example. In 1998, Cruise Corp. adopted a defined-benefit excess plan with a calendar plan year. For the 1998 through 2003 plan years, the plan's integration level for each participant was based upon the 1998 covered compensation table and was permissible. However, the integration level must be changed for the 2004 plan year and may be the covered compensation table for the 1999 or any later plan year.⁴⁰

³⁹ IRC Section 401(l)(5)(C); Treas. Reg. Sections 1.401(a)(4)-3(e)(2)(i), 1.401(l)-1(c)(2).

⁴⁰ IRC Section 401(l)(5)(E); Treas. Reg. Section 1.401(l)-1(c)(7); Rev. Rul. 2003-124 (2003-49 I.R.B. 1); Notice 89-70 (1989-1 CB 730).

Although an increase in covered compensation will result in a smaller benefit at retirement, a participant's accrued benefit may not be reduced because of the increase in covered compensation.⁴¹

Defined-Benefit Plan Uniform Disparity Rule

With respect to qualified retirement plans that provide for permitted disparity, the disparity for all participants under the same plan must be uniform.⁴²

The disparity provided under a defined-benefit excess plan is uniform only if the plan uses the same BBP and the same EBP for all participants with the same number of years of service.

The disparity provided under a defined-benefit offset plan is uniform only if the plan uses the same gross benefit percentage and the same offset percentage for all participants with the same number of years of service. However, an exception to these rules applies if the plan provides that, in the case of an employee for whom no FICA taxes are required to be paid, employer-provided benefits are determined with respect to the participant's total average annual compensation at the EBP or gross benefit percentage applicable to a participant with the same number of years of service.⁴³

Top-Heavy Plan Restrictions

A top-heavy defined-benefit plan must provide each participant who is a non-key employee with a minimum annual retirement benefit, and a top-heavy defined-contribution plan must provide each participant who is a non-key employee with a minimum annual contribution. A top-heavy plan cannot take into account Social Security benefits or contributions to satisfy these minimum requirements.⁴⁴

Effect of Plan Termination

If a defined-benefit plan providing for permitted disparity is terminated and the plan assets exceed the present value of the accrued benefits, the use of the excess funds to increase benefits under the plan must not violate the permitted disparity rules.⁴⁵ The termination of a qualified retirement plan may not discriminate in favor of HCEs.⁴⁶

⁴¹ IRC Section 411(d)(6).

⁴² Treas. Reg. Sections 1.401(l)-2(a)(4), 1.401(l)-3(a)(4).

⁴³ Treas. Reg. Sections 1.401(l)-3(c)(1), 1.401(l)-3(c)(2)(vii).

⁴⁴ IRC Section 416(e); Treas. Reg. Section 1.416-1, Q&A M-11.

⁴⁵ Rev Rul 80-229 (1980-2 CB 133).

⁴⁶ Treas. Reg. Section 1.401(a)(4)-5(a)(1).

2004 Covered Compensation Tables

The following are tables of covered compensation under IRC Section 401(l)(5)(E) for the 2004 plan year. The tables are used for determining contributions to defined-benefit pension plans and permitted disparity.⁴⁷

2004 Covered Compensation Table

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2004 Covered Compensation Table
1907	1972	\$ 4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312

⁴⁷ Rev. Rul. 2003-124 (2003-49 I.R.B. 1).

2004 Covered Compensation Table *(continued)*

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2004 Covered Compensation Table
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,128
1934	1999	33,060
1935	2000	35,100
1936	2001	37,212
1937	2002	39,444
1938	2004	43,992
1939	2005	46,284
1940	2006	48,576
1941	2007	50,832
1942	2008	53,028
1943	2009	55,164
1944	2010	57,276
1945	2011	59,352
1946	2012	61,392
1947	2013	63,396
1948	2014	65,256
1949	2015	67,020
1950	2016	68,688
1951	2017	70,272
1952	2018	71,760
1953	2019	73,200
1954	2020	74,580
1955	2022	77,148
1956	2023	78,372
1957	2024	79,512

(continued)

2004 Covered Compensation Table *(continued)*

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2004 Covered Compensation Table
1958	2025	80,556
1959	2026	81,540
1960	2027	82,464
1961	2028	83,340
1962	2029	84,120
1963	2030	84,876
1964	2031	85,596
1965	2032	86,244
1966	2033	86,796
1967	2034	87,240
1968	2035	87,564
1969	2036	87,780
1970	2037	87,864
1971 and later	2038	87,900

2004 Rounded Covered Compensation Table

Year of Birth	Covered Compensation
1937	39,000
1938–1939	45,000
1940	48,000
1941	51,000
1942–1943	54,000
1944	57,000
1945–1946	60,000
1947	63,000
1948–1949	66,000
1950–1951	69,000
1952–1953	72,000
1954	75,000
1955–1956	78,000
1957–1960	81,000
1961–1963	84,000
1964–1967	87,000
1968 and later	87,900

Chapter 8

Internal Revenue Code Section 401(k) and Safe-Harbor 401(k) Plan Design

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Internal Revenue Code Section 401(k) and Safe-Harbor 401(k) Plan Design

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This chapter discusses the peculiarities of the Internal Revenue Code (IRC or the Code) Section 401(k) plan (401(k) plan) and the special rules that apply to these plans with regard to nondiscrimination and other significant design issues. We also cover the special subcategory of safe-harbor 401(k) plans and how they can be designed to avoid some of the difficulties of the otherwise required nondiscrimination rules. It is intended that this be a general explanation and not a detailed explanation of the many provisions, rules, and complexities of 401(k) plans.

401(k) Arrangements

401(k)—A Feature, Not a Plan

In light of the constant attention given to 401(k) plans by the media, including the financial press, it may come as a surprise that there really is no such thing as 401(k) *plans* (even though everyone—including the Internal Revenue Service (IRS)—refers to them this way). In fact, a 401(k) plan would be much better referred to as a *feature* that is added to either a profit-sharing plan (most frequently) or a stock bonus plan (less frequently) or a pre-ERISA (meaning, before the Employee Retirement Income Security Act of 1974; that's before 1974!) money-purchase plan that was grandfathered when ERISA was passed. The latter is so rare that I have never seen one and do not know anyone who has. We will assume, in this chapter, that the 401(k) feature is always part of a profit-sharing plan.

Cash or Deferred Arrangements

If you look up Internal Revenue Code (IRC or the Code) Section 401(k), you will find that it actually addresses “cash or deferred arrangements,” which we refer to as a CODA. A *CODA* is simply an option that is provided to a participant in a retirement plan under which the individual has the right to elect either to take their income from their employer in the form of *cash* wages (most common), or, if they are so inclined, to *defer* wages directly into the retirement plan on a pretax basis. Neither federal nor state income taxes are paid on wages that are deferred into the 401(k) part of the retirement plan. Note, however, that Social Security taxes (including Medicare) are paid on amounts deferred into a 401(k) program.

General Requirements of 401(k) Plans

Nondiscrimination Testing

401(k) plans are subject to what is called the actual deferral percentage test (ADP test). This test is used to limit the deferrals allowed by highly compensated employees (HCEs). The employer determines the percentage of compensation deferred by each participant under the 401(k) arrangement. The ADP test compares the average deferral rates of the nonhighly compensated employees (NHCEs) with the average deferral rates of the HCEs. If the HCE rate exceeds the NHCE rate by more than a permitted range, the plan will not meet the requirements of the test.

It is possible for a plan to be designed to automatically meet the requirements of the ADP test. In fact, a plan is deemed to pass the ADP test if it satisfies the requirements of what is known as a *safe-harbor 401(k) plan*, which is described in IRC Section 401(k)(12). We will discuss these safe-harbor provisions later in the chapter.

We should note here that there is also something called the actual contribution percentage test (ACP test), a special nondiscrimination test. The portion of a plan that consists of employee contributions and/or matching contributions is subject to its own testing. The ACP test is applied to these contributions under IRC Section 401(m). Since matching contributions are most often found with a 401(k) feature, the 401(m) testing (ACP) often goes hand in hand with 401(k) plans and ADP testing.

Vesting

All elective deferrals (that is, the contributions made by the employees out of their otherwise payable wages) must be 100 percent vested at all times in a 401(k) plan.

Eligibility to Defer

An employee cannot be required to complete more than one year of service as a condition of participation in a 401(k) program. This is more restrictive than the general rule that allows for up to a two-year requirement in plans that do not have a 401(k) feature.

Distribution Restrictions

The elective deferrals made to a 401(k) plan are not as readily available for distribution as other funds in qualified retirement plans as a result of special restrictions that apply to 401(k) money. For example, the money cannot be paid out prior to age 59½ as an in-service distribution (but it can, of course, be paid out in the event of death, disability, or termination of employment).

Contingent Benefit Rule

This rule provides that no other employer-provided benefits, except a matching contribution, can be conditioned upon whether the employee elects to participate in the 401(k) arrangement. Thus, the only *arm twisting* that can be done to employees to get them to participate in the 401(k) plan is to offer them a match that is conditioned on their contributing their own funds to the plan. The contingent benefit rule prevents the employer from using the enticement of other employer-provided benefits in the plan that includes the section 401(k) arrangement (other than the noted matching contributions), or in another qualified plan maintained by the employer, or health benefits, vacation, life insurance, loans, or nonqualified deferred compensation benefits.

Who can establish a 401(k) plan?

Any regular business, whether established as a corporation, partnership, sole proprietorship, LLC, or LLP is free to establish a 401(k) plan. The provisions of the 401(k) can and do apply to self-employed individuals and partners as well as those employees who actually receive Form W-2, Wage and Tax Statements.

A governmental entity may not maintain a 401(k) arrangement if the entity is a state or local government; a political subdivision of a state or local government; or an agency or instrumentality of such state, local government, or political subdivision. There is an exception for governmental employers who maintained a 401(k) arrangement that had been in existence as of May 6, 1986.

Note that nongovernmental tax-exempt organizations are now permitted to establish and maintain 401(k) arrangements, without limitation. Thus, a charitable organization under 501(c)(3) may establish a 401(k) arrangement if it so desires. For the record, however, there was a prohibition in effect from 1987 to 1996 prohibiting these organizations from establishing 401(k) plans during that time.

Lastly, IRC Section 401(k)(4)(iii) expressly allows an Indian tribal government to establish a 401(k) arrangement under the rules that apply for nongovernmental tax-exempt organizations.

401(k) Deferral Limits

IRC Section 402(g) sets a limit on the amount of elective deferrals that may be excluded from gross income by an individual in a single calendar year. This limit is applied on an individual taxpayer basis and applies across multiple employers (if there are multiple employers). Thus, a single taxpayer cannot exceed the annual maximum limit by contributing to two plans with two different employers. The amount deferred is reported on the Form W-2 of the employee and that is how a contribution in excess of the 402(g) limit will be caught by the IRS computers.

In 2004, the maximum regular limit for what can be deferred under a 401(k) plan is \$13,000. This amount is increasing by \$1,000 each year for the next two years so that it is \$14,000 in 2005 and \$15,000 in 2006.

Catch-Up Contributions

An individual who is at least 50 years old and who participates in a 401(k) plan has an additional amount available that can be deferred beyond the numbers noted above. These are the catch-up contribution rules under IRC Section 414(v) that allow an individual to exclude from his or her gross income elective deferrals that exceed the IRC Section 402(g)(1)(A) limit, up to an annual catch-up limit. These catch-up amounts were added by the 2002 tax law enacted by Congress.

Practice Pointer: These catch-up contributions also work to increase the overall maximum that a participant could otherwise receive in a given year from a retirement plan. Only elective deferrals that satisfy the catch-up rules provide for this increase. Thus, it is only through having a 401(k) feature that a plan may exceed the otherwise allowable maximum contribution under IRC Section 415 limit (currently \$41,000 per year).

In 2004, the additional catch-up contribution allowed is \$3,000. That will increase by \$1,000 in each of the next two years, so that in 2005, the catch-up amount will be \$4,000 and in 2006 the catch-up amount will climb to its currently scheduled maximum of \$5,000. If a participant is over age 50 in 2006, he would be able to get a maximum IRC Section 415 maximum of \$41,000 (currently) *plus* an additional \$5,000 for the catch-up which brings the overall maximum allocation to \$46,000 in 2006.

Discrimination Testing Details

The ADP test (or, in its place, the safe-harbor 401(k) option) is the exclusive means of showing the 401(k) arrangement satisfies the nondiscrimination requirements of the law.

The ADP is determined by averaging the deferral percentages separately calculated for the eligible employees in the 401(k) arrangement. An employee's deferral percentage is the percentage of his compensation that has been deferred to the plan through the 401(k) arrangement (not including catch-up contributions).

One ADP is calculated for the eligible employees who are in the HCE group, and another ADP is calculated for the eligible employees who are in the NHCE group. The purpose of the ADP test is to set a limit on the ADP for the HCE group. To pass the test, the ADP of the HCE group must satisfy the 1.25 test or the 2-percent spread test.

1.25 Test

This test is satisfied if the ADP of the HCE group does not exceed 1.25 times the ADP of the NHCE group. For example, if the ADP of the NHC group is 4 percent, the ADP of the HCE group would be limited to 1.25×4 percent, or 5 percent.

2-Percent Spread Test

This test is satisfied if the ADP of the HCE group is not more than two percentage points greater than the ADP of the NHC group, and the ADP of the HCE group is not more than twice the ADP of the NHC group. In other words, to arrive at the limit for the HCE group, add 2 percent to the NHC group's percentage or double that percentage, whichever produces the smaller result.

Rule of Thumb

If the ADP of the NHCEs is 2 percent or less, the maximum allowed for the HCEs would be 200 percent of the NHCE level. If the ADP of the NHCEs is between 2 percent and 8 percent, the maximum allowed for the HCEs would be the ADP of the NHCEs plus 2 percent. And if the ADP of the NHCEs was 8 percent or greater, the maximum allowed for the HCEs would be the ADP of the NHCEs times 1.25. The chart would look like this:

If ADP of NHCEs Is:	Then Maximum ADP for HCEs Is:
0–2%	200% of NHCE ADP
2–8%	ADP of NHCE <i>plus</i> 2%
8% or more	125% of NHCE ADP

Choices in ADP Testing

There are a number of choices to be made in how to apply the ADP testing. One choice is whether data from the current year or the prior year for NHCEs is going to be used to determine what the HCEs can defer in the current year. These two choices are known as *prior year testing* or *current year testing*. In either case, you are really testing the current year for the HCEs, but either using prior-year or current-year data as they relate to calculating the ADP of the NHCEs. The chosen methodology used must be specifically provided in the plan document, and there are rules about making changes from one method to another. The default method is prior-year testing, and switching from prior year to current year is always permitted.

To change from current year to prior year, the plan must have used current year for at least the five preceding plan years (or all prior years if the plan has been in existence for fewer than five years).

We failed! What now?

If the ADP (or the ACP) test is failed, corrective action must be taken during the *applicable correction period* provided by the IRS regulations. This period is the plan year of 12 months *following* the close of the plan year in which the failure has occurred. Failure to correct an ADP violation can result in the plan being disqualified.

The correcting methodology is relatively complex and beyond the scope of our discussion here, but, unless the employer is going to make additional contributions for the NHCEs, it involves disgorging back to the HCEs enough of their deferrals so that the plan is deemed to pass the ADP test. It is particularly interesting to note that the methodology now required by the IRS, when used, results in a situation in which the plan *still does not pass the mathematical ADP test*, but if done in accordance with the IRS guidance, the plan will be *deemed* to have met the ADP test. The distributions that must be made also include a share of the allocable earnings for the plan year, calculated using any reasonable method. It is also possible that an additional adjustment must be made for the earnings attributable to the *gap period*, which is the period of time from the end of the plan year in which the failure occurred to the actual time of the distribution of the excess amounts to the HCEs. If the allocable earnings is a loss, the amount actually distributed will be less than the excess amount.

Tax Treatment of Corrective Distribution

A corrective distribution of elective deferrals is fully taxable since amounts distributed to correct an ADP test violation are attributable to pretax contributions. (A corrective distribution under the ACP test might not be fully taxable since employee contributions may have been after-tax contributions). Allocable income distributed with either ADP or ACP violation distributions will also be taxable.

The timing of when a corrective distribution is made affects the year in which the income is included for the individual participant. Different rules are provided for corrective distributions that are made within the first two and one-half months of the correction period than for corrective distributions that are made after the first two and one-half months of the correction period. In addition, the employer is liable for an excise tax when corrective distributions are made after the first two and one-half months of the correction period.

Distributions Made in the First Two and One-Half Months of the Correction Period

If the distribution is in the first two and one-half months of the 12-month correction period, the taxable amount is generally included in the income for the taxable year of the participant that *precedes* the taxable year in which the distribution occurs. This could require that the individual receiving the distribution might have to file an amended income tax return since the amount is going to be attributed to a prior tax year and it is possible that the tax return for that year has already been filed.

Distributions Made After the First Two and One-Half Months of the Correction Period

If the excess amounts are distributed *after* the first two and one-half months of the correction period, the amount includible in income is taxable for the year in which the distribution is made. In addition, if distributions are made after the first two and one-half months of the correction period, the *employer* is liable for an excise tax on the amount distributed.

Employer Excise Tax for Corrective Distributions Made After Two and One-Half Months

If corrective distributions are made after the first two and one-half months of the correction period, the employer (not the HCE) is liable for an excise tax under IRC Section 4979. The amount of the excise tax is equal to 10 percent of the amount of the excess contribution (determined before the adjustment for allocable earnings). The employer is liable for paying the excise tax and does so by Form 5330. The due date for payment is the last day of the fifteenth month following the close of the plan year.

Reporting the Corrective Distributions Using Form 1099-R

The IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., is used to report corrective distributions. The form for the current calendar year of the distribution must be used, even if the distribution is taxed in a prior year. For example, a distribution that occurs on March 1, 2005, to correct a violation of the ADP test for the plan year ending December 31, 2004, is reported on the 2005 Form 1099-R, even though the distribution is included in income for 2004.

Another Way to Fix a Failed Test: Qualified Nonelective Contributions

Rather than refunding deferrals to HCEs, it is possible for an employer to *fix* a failed ADP (or ACP) test by the use of qualified nonelective contributions (QNECs). These are simply additional *employer contributions* made to the NHCEs which act as a *booster* in bringing up the ADP or ACP of the NHCEs. Of course, this requires that the employer would be willing to contribute its own additional dollars rather than refund money to the HCEs. A complete discussion of how QNECs are calculated is beyond the scope of this discussion.

Safe-Harbor 401(k) Plans

The IRC provides an alternative to having to do all this testing and comparing of contributions made by HCEs against the contributions made by the NHCEs. IRC Section 401(k)(12) provides that if a 401(k) plan satisfies the conditions in that section, the ADP test is deemed satisfied. A 401(k) plan that satisfies the requirements of IRC Section 401(k)(12) is known as a safe-harbor 401(k) plan. To qualify for the ADP safe harbor, the 401(k) plan must satisfy the following conditions:

1. A safe-harbor contribution requirement
2. A vesting requirement
3. Withdrawal restrictions
4. An annual notice requirement

Safe-Harbor Contribution Requirement

This requirement is met if the employer makes either a safe-harbor matching contribution or a safe-harbor nonelective contribution to satisfy the safe-harbor contribution requirement. The safe-harbor contributions are required to be provided to NHCEs, but do not have to be provided to HCEs if the plan is so designed.

The matching contribution must be no less than a 100-percent match on the first 3 percent of compensation deferred, plus a 50-percent match on the next 2 percent of compensation deferred. Thus, if an employee defers at least 5 percent of his or her compensation, the employer match will max out at an amount equal to 4 percent of that individual's compensation. As an alternative to the matching contribution, a safe-harbor nonelective contribution may be adopted to meet the safe-harbor contribution requirement. A nonelective contribution will satisfy the ADP safe-harbor contribution requirement if it equals at least 3 percent of the employee's compensation. As with the match, the nonelective contribution need only be provided to the eligible NHCEs. However, the plan may provide that the HCEs also receive the nonelective contribution allocation. Note that this is not a match; an eligible NHCE must receive the allocation of the nonelective contribution regardless of whether he chooses to make deferrals under the IRC Section 401(k) arrangement. Some employers prefer the nonelective contribution because it does not discriminate

among the employees based on their own financial circumstances and their individual abilities to defer into a 401(k) arrangement. In addition, this safe-harbor provision will also meet the minimum contribution requirement for a plan that is *top heavy*.

There can be no exception to an eligible employee's right to accrue the minimum contribution. The plan cannot require that the eligible employee complete a minimum number of hours of service for the plan year (e.g., 1,000 hours) or be employed on the last day of the plan year in order to be entitled to the minimum matching contribution or the minimum nonelective contribution. The IRS guidance provides that the safe-harbor contribution must be provided to all NHCEs who are eligible employees under the IRC Section 401(k) arrangement.

Safe-Harbor Vesting Requirement

The safe-harbor contribution must be 100-percent vested at all times, regardless of the employee's length of service. Amounts that are not part of the safe-harbor contribution can be subject to the normal vesting rules applicable to qualified plans.

Safe-Harbor Withdrawal Restrictions

Participant withdrawals of the ADP safe-harbor contributions are restricted. No hardship withdrawals are permitted with respect to safe-harbor employer contributions.

Annual Notice Requirement

A safe-harbor 401(k) plan must provide the eligible employees an annual written notice which describes the employee's rights and obligations under the arrangement. The annual notice requirement was a necessary element to obtaining the Department of the Treasury's support for the legislation that created the safe-harbor option. With the elimination of the ADP test, the Treasury was concerned that an employer would have less incentive to encourage enrollment by the NHCEs. In fact, where the safe-harbor matching contribution formula is provided, an employer might prefer lower enrollment, so its matching contribution costs are reduced. The annual notice requirement will serve as a reminder to the employees of the advantages of participating in the 401(k) arrangement and how they make (or modify) deferral elections.

Comment on Employee Direction of Investments in a 401(k) Plan

Though most 401(k) plans provide for employee direction of some or all of the plan investments, this is not required by law. It is perfectly permissible for a plan to provide that some or all of the money in the plan, including the employee elective deferrals, are invested only under the direction of the trustees,

and the employee has no election with regard to where the funds are invested. A discussion of the pros and cons of employee-directed investments is beyond the scope of this presentation, but be aware that there are well-reasoned arguments for not allowing employee investment direction and that plans that are written that way are completely within the scope of the law.

Chapter 9

Defined-Contribution Cross-Tested, General Tested Plan Design

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If a defined-contribution plan is not designed to automatically pass the various Internal Revenue Service (IRS) nondiscrimination tests, then it must be tested under an extremely complex and almost mysterious set of IRS rules, known as the general test for nondiscrimination, often referred to as the general test. The general test rules offer a multitude of methodologies to prove that your plan, in operation, is nondiscriminatory (as defined by the IRS). A complete analysis of the general nondiscrimination rules is well beyond the scope of this chapter; some suggest that they are well beyond the scope of comprehension. Nevertheless, this chapter reviews the important aspects of this approach to plan design for the small business retirement plan so the practitioner will be aware that there are many options for creative plan design which a competent qualified plan consultant will be able to suggest.

A good friend of mine, who is, perhaps, the world's expert on nondiscrimination testing, has often said that under the extremely complex and voluminous IRS rules, every plan will pass the nondiscrimination rules. It is simply a matter of knowing how the rules work, and then testing and retesting the plan under the large number of methods with their enormous number of alternatives, until either the plan passes the tests, or the client runs out of money to pay the consultant's fees!

What is this all about?

If the truth be told, it is all about *discrimination*—not the illegal kind, but the absolutely legal and permissible kind that is sanctioned by the United States Government in the guise of the IRS. If we look at the design of a retirement

plan for what we generally refer to as a *small business*, we find that the owners of the business are very often particularly interested in receiving a relatively significant benefit from the retirement plan, while keeping the cost (and, thus, the benefits) for the rank-and-file employees at a minimum cost. Some might raise an eyebrow over a plan under which Dr. Bigbucks (who earns \$205,000 per year) gets an allocation for the plan year of \$41,000 while his hardworking but modestly paid (\$30,000 per year) assistant (who is the only full-time employee; all others on the payroll never work more than 18 hours a week, every week) gets an allocation of \$1,500. Given the right *demographics* (the ages of the doctor and the assistant being “good”), it is perfectly possible and permissible that such a design would be acceptable (that is, it will pass the general test for nondiscrimination). Is it *discriminatory*? Of course it is! The good news is that it is not *impermissibly discriminatory*, and that is what this chapter is all about.

The nondiscrimination rules are a complex web of interrelated rules covering various sections of the Internal Revenue Code (IRC or the Code). These include the coverage rules under IRC Section 410(b), the nondiscrimination rules under IRC Section 401(a)(4), and the definition of compensation under IRC Section 414(s).

Rate Group Testing for Defined-Contribution Plans (the General Test)

Rate group testing is a more precise term for the IRS's general nondiscrimination test in Treasury Regulations Section 1.401(a)(4)-2(c). If a defined contribution plan's design does not fit into one of the safe-harbor categories that were discussed in an earlier chapter in this book, then the plan is subject to this rate group testing. In the most basic terms, this rate group testing is simply a method of showing that the allocations of contributions (that is, the plan benefits) are nondiscriminatory. This is done by analyzing these things called *rate groups*, and showing that each rate group can satisfy certain provisions of the tests. Here, each rate group must satisfy one of the coverage tests under IRC Section 410(b).

Determining Rate Groups

Since we must test *each* rate group, we will need to figure out just what a rate group is. Rate group testing requires annual testing and looks at the individual participants in the plan and the benefits they are getting under the plan. To determine our rate groups, we must express each participant's allocation under the plan in the form of either an *allocation rate* or an *equivalent benefit accrual rate* (also known as an EBAR), applying the same method to everyone under the plan.

The allocation rate just referred to is simply the amount of dollars allocated (including contributions and forfeitures). So what is an EBAR, and how does it work?

Equivalent Benefit Accrual Rate—Cross-Testing

If we were to take the dollars allocated to an individual's account for a given year and use some mathematical process to project those dollars forward with earnings to the participant's normal retirement age, and then convert that accumulated amount to a monthly benefit that could be provided to them for the rest of their life, we will have covered the concept of calculating an EBAR. In effect, we are converting the dollar allocation under the defined-contribution plan to a monthly benefit payable at retirement age for this participant. By dividing that monthly benefit by the compensation of the participant, we have just calculated an equivalent benefit accrual rate. The EBAR is basically the determination of how much the current allocation in a defined-contribution plan would buy (as a percentage of the participant's current compensation) as a benefit at retirement on a defined-benefit basis.

The use of EBARs is referred to as *cross-testing*, because it is converting a defined-contribution allocation to a defined-benefit concept and then testing the benefits provided to the participants on a benefits basis. We are testing defined contribution dollars on a defined-benefit basis—thus, cross-testing!

The Basics of Cross-Testing

Cross-testing is just a different way of performing the rate group testing. If we take each and every participant in the plan and project their allocation to retirement age to calculate their EBAR, we can then order the employees from highest to lowest based on the size of their EBAR.

The most significant factor of the determination of EBARs is that the younger the participant is (that is, the further away from normal retirement age they are), the larger will be their EBAR per dollar of allocation. The IRS provides rules for how to do the math that converts current dollars to EBARs. Probably the most significant item is the interest rate that can be used to project these allocations forward to retirement age.

The IRS allows us to use a range of rates from 5½ percent to 8½ percent to project the values at retirement. The effect of a higher interest rate on compound interest over time is to give significantly higher values at the accumulation point (retirement age). A contribution of \$1 allocated to a 25-year-old growing at 8½ percent to age 65 will be much, much larger than \$1 allocated to a 45-year-old growing at that same rate to age 65. Thus, younger participants will get higher values at age 65 (their EBARs will be much greater) per dollar of allocation than will older participants.

It is this mathematical process that works favorably to allow our Dr. Bigbucks to get his \$41,000 allocation while his assistant gets a meager \$1,500. The doctor's allocation of \$41,000 is 20 percent of his compensation of \$205,000; but the assistant's \$1,500 is only 5 percent of her \$30,000 compensation. Yet, when we compare the value of those contributions projected to retirement age, the 25-year-old assistant's contribution is actually more valu-

able as a percentage of her pay (on a projected defined-benefit basis due to the enormous effect of compound interest over a 40-year period) than is the \$41,000 allocation to our 62-year-old doctor. Mathematically, and using the IRS regulations, we can show that the assistant's current 5-percent contribution is more valuable than the doctor's 20-percent current contribution, when both are projected forward to retirement age.

And that is the magic of *cross-testing*.

Figuring Out Your Rate Groups Using EBARS

Now that we know the basics of calculating EBARS, we can return to the determination of our rate groups. We have calculated an EBAR for each and every participant in the plan. We can now rank the participants by their EBAR (from largest EBAR to smallest). We want to pay particular attention to where each and every highly compensated employee (HCE) appears in our ranking. The reason for this is that the number of rate groups is exactly equal to the number of HCEs in the plan. Each and every HCE forms his or her own rate group, and the members of that group consist of that HCE and every other participant (including other HCEs) who have an EBAR equal to or greater than that HCE's EBAR.

This does mean that participants can and will be in more than one rate group. For example, if HCE1 has a smaller EBAR than HCE2, then HCE2 (and all other participants who have an EBAR greater than HCE1) will be in HCE1's rate group. In addition, all participants who have an EBAR greater than HCE2's EBAR will be in the rate group of HCE2, even though they were already in the rate group of HCE1. The rate groups will become smaller in number of both HCEs and nonhighly compensated employees (NHCEs) as the EBARS increase. By the way, if two HCEs have the same EBAR, we only need to test their rate groups as a single rate group since the members of each of their rate groups will be identical, and if one rate group passes, then so will the other.

Example. Assume a profit-sharing plan with 3 HCEs that is a cross-tested plan. The EBARS for the HCEs are 5.47 percent for HCE1, 8.89 percent for HCE2, and 10.66 percent for HCE3.

There will be three rate groups to test, one for each of the HCEs. The 10.66-percent rate group includes HCE3 and all NHCEs with an EBAR equal to or greater than 10.66 percent. The 8.89-percent rate group includes HCE2 and HCE3 and all NHCEs with an EBAR equal to or greater than 8.89 percent. Last, the 5.47-percent rate group includes all three HCEs and all NHCEs with an EBAR equal to or greater than 5.47 percent.

If there are NHCEs with EBARS lower than 5.47 percent, they will *not* be in any rate group, and that is fine.

Example. The facts are the same as in the preceding example, except that the HCE2's EBAR also was 10.66 percent. Now, there will be only two

rate groups to test, the 10.66-percent rate group which includes HCE2 and HCE3, and the 5.47-percent rate group which includes all three HCEs.

Rate Groups and Coverage Testing

Now that we know which participants are in our rate groups, we can do our rate group testing. Every rate group must satisfy the coverage requirements of IRC Section 410(b). There is a choice of two tests, the passing of either one of which will mean that our rate group passes the nondiscrimination testing. For the plan as a whole to pass, all the rate groups must pass one of these tests. Those tests are known as the *ratio percentage test* and the *average-benefits test*. The rate groups do *not* have to all pass the same test; it is enough that each rate group pass either one of the tests.

The Ratio Percentage Test

In order to pass this test, we will calculate something called the coverage ratio. In order to pass, the coverage ratio for the rate group must be at least 70 percent. We start by assuming that the employees who are in the rate group are the only employees in the plan. We now calculate *two* ratios, namely, the NHCE ratio and the HCE ratio. A ratio has a numerator and a denominator. The NHCE ratio for the rate group has as its numerator the number of NHCEs who are included in the rate group under discussion, and the denominator is the number of *all* NHCEs (other than certain excludable employees such as those who have not yet met the age and service conditions for eligibility in the plan, union employees, and employees who terminated during the plan year with fewer than 500 hours of service). Note that the denominator will pick up those employees who have met the age and service requirement even if they are otherwise excluded from the plan by employment classification or specifically excluded by name.

The HCE ratio is calculated in the same way; it has a numerator of those HCEs who are included in the rate group and a denominator of all HCEs of the employer.

To calculate the coverage ratio, you take the NHCE ratio calculated above and divide by the HCE ratio. If this is at least 70 percent, the rate group passes the ratio percentage test.

A way to say the formula in English is that the percentage of NHCEs covered in the rate group must be at least 70 percent of the percentage of HCEs covered in the rate group. For example, if your rate group covers one out of two HCEs (which is 50 percent), then you would have to cover 70 percent of that percentage, which would mean having to cover 35 percent of the NHCEs in the rate group.

The Average-Benefits Test

If any rate group cannot pass the ratio percentage test as described above, then it must pass the average-benefits test in order for the plan as a whole to be nondiscriminatory under the IRS regulations.

The average-benefits test has two distinct parts, both of which must be passed:

- The nondiscriminatory classification test
- The average-benefits percentage test

The Nondiscriminatory Classification Test

The first part of the test is to show that the rate group passes this nondiscriminatory classification test. This is done in the same manner as the ratio percentage test shown above, but with a different passing level. To pass the nondiscriminatory classification test, the coverage ratio must be at least equal to the midpoint between the applicable safe-harbor percentage and unsafe-harbor percentage in Treasury Regulations Section 1.410(b)-4 (or the plan's actual ratio percentage, if less).¹

The coverage ratio needed to pass the test will depend on what percentage of the work force (other than excludable employees) is made up of NHCEs (known as the *NHCE concentration percentage*). The required coverage ratio for the rate group will never be greater than 45 percent, and may be as little as 20.75 percent, depending on the NHCE concentration percentage. If the rate group does not satisfy this step, do not go any further. The rate group fails the average-benefits test, and allocations will need to be increased for some or all of the NHCEs in order to pass this test. If every rate group passes the nondiscriminatory classification test, then the rate group test is satisfied only if the plan satisfies the average-benefits percentage test, as described below.

The Average-Benefits Percentage Test

The second part of the test is to show that the average-benefits percentage for the employer's plans is at least 70 percent. This step is performed at the employer level, taking into account all plans maintained by the employer that are required to be included in the average-benefits percentage.

To do this test, we need to have all the EBARS for all the employees calculated (other than excludable employees for coverage testing purposes), regardless of whether the NHCE benefits from any rate group being tested under the plan or even is a participant in the plan. Separate the HCE numbers from the NHCE numbers. Then, calculate the sum of the NHCE EBARS and divide by the number of NHCEs in the calculation (here we are determining the average EBAR of the NHCEs). Express the result as a percentage.

¹ See Treas. Reg. Section 1.401(a)(4)-2(c)(3)(ii)

Now do the same for the HCEs. Determine the average of their EBARS.

Divide the percentage for the NHCEs by the percentage for the HCEs. The result is the plan's average-benefits ratio. If the average-benefits ratio is at least 70 percent, and each rate group has passed the nondiscriminatory classification test as described above, the plan satisfies this rate group testing method, the average-benefits test.

Gateway Testing

Effective for plan years beginning in 2002, if a plan is going to rely on cross-testing to meet the nondiscrimination rules, it must also pass a new gateway test as a precondition to using the cross-testing methodology.

The gateway provisions provide for a gateway contribution test. Under this test, the lowest permissible allocation rate for any NHCE who benefits under the plan is one-third of the highest allocation rate for any HCE who benefits under the plan. This is generally called the *one-third test*. However, if each NHCE receives an allocation that is no less than 5 percent of their compensation, the gateway is deemed satisfied. This is referred to as the 5-percent test. Thus, for plans that generally provide an allocation to all eligible NHCs that equals or exceeds 5 percent of compensation, the regulations will have little or no impact.

Example. If the HCEs in a plan that utilizes cross-testing to show non-discrimination are receiving an allocation of 20 percent of compensation, then the NHCEs must receive an allocation that is one-third of that amount (6.67 percent) or 5 percent, whichever is smaller. In this case, a 5-percent allocation to the NHCEs would meet the gateway contribution. On the other hand, if the HCEs received a contribution of 12 percent of compensation, then the NHCEs need only receive an allocation of 4 percent since that would be one-third of the HCE allocation and 5 percent would exceed that amount.

Cross-Tested Plan Design Basics

In the preceding material, we have looked at only a small portion of the rules and processes for general testing a retirement plan for the purposes of determining what is and what is not discriminatory within the eyes of the IRS. It is critical that the reader understand that it is *not* our intention that reading the preceding material (and even understanding it) will equip you to actually do any of this testing. The rules and regulations are extremely complex and we have only touched on most of the concepts. They are all much more complicated than this treatment allows us to explain, with well over 300 pages of actual regulations attempting to provide more complete guidance. In the designs of retirement plans that are meant to comply with these nondiscrimination

rules, the involvement of a competent professional retirement plan consultant is absolutely imperative. This is *not* an area where you can “go it alone.”

There are simple retirement plan designs, often represented by plan documents provided in what is known as a *prototype* document, specifically, a standardized prototype document. This document, as designed by the IRS itself, is extremely limited as to what is allowed to be selected. The resulting plan, if operated in accordance with that document, tends to be more generous to the NHCEs than the law requires. These documents have also been compared to “giving away the store” to the rank-and-file employees. Moreover, noncompliance with the prototype document is likely, unless there is a *competent* retirement plan professional or organization involved.

If your small business client is looking to design a retirement program from which the owners and HCEs will receive significant benefits and the rank-and-file employees will benefit to a much smaller degree, then a plan that utilizes the demographics of the employee group and relies on general testing (or cross-testing) is very often the plan of choice.

Let us look at some design options that are normally utilized in a cross-tested plan.

The Demographics of the Group

The key demographic features that allow a cross-tested plan to best meet an employer's objectives for its retirement plan program is to have older, higher paid owners and younger, lower paid rank-and-file employees. This is a *general* requirement, and the older the owners and the younger the employees, the more likely that a cross-tested plan design will work. By “work,” we mean that we will be able to provide significantly greater benefits to the owners at a reasonable cost for the rank-and-file employees. Generally, the lowest cost for rank-and-file employees in order to pass the general test will be to provide just the amount necessary to meet the gateway contribution tests noted above. In most cases, this minimum will be a 5-percent contribution to the NHCEs, since the HCEs will be receiving a benefit that is at least three times that.

Having demographics does not mean that you cannot have older rank-and-file employees and younger owners. It just doesn't help our overall testing to have such combinations. But the real world of client employee populations often presents such real world situations, and they must be factored into designing the appropriate plan provisions to accomplish the employer's objectives.

Let's look at some basic cross-tested design ideas; remember that in real life, these situations will almost always be much more complicated, and these plans need to be continuously monitored to make sure they will be able to pass the nondiscrimination tests each and every year.

Super Integrated Designs

Many retirement plans that are *not* intended to be cross-tested utilize something that traditionally has been called *integration with Social Security* and is now more appropriately called utilizing permitted disparity. These design-based, safe-harbor plans allow for a slightly higher allocation to those employees who have higher income levels. The concept here is that since Social Security benefits (half of which are paid for by the employer's contributions to Social Security, which is equal to the employee's tax) provide a higher *percentage* benefit to lower income earners, the employer's retirement plan is allowed to offset that inherent inequity by allowing the employer to provide a slightly larger allocation to the higher paid employees in the employer's plan. This process is very tightly controlled by IRS regulations, and the amount of additional allocation to the highly compensated is limited if the plan is going to continue to be a safe-harbor, design-based program.

In a cross-tested design, we take this concept of Social Security integration and significantly enlarge it. An example of a super integrated formula might be an allocation provision under which all the employees get, first, an allocation of 5 percent of their compensation across the board. Note that this 5-percent contribution will meet the gateway test for cross-testing. Then, after this contribution is allocated to all participants (including our highly compensated owners), a second level of allocation is provided of, say, 100 percent of compensation in excess of \$100,000. Let us look at an example of how the math works.

Assume an owner whose compensation is higher than the maximum the law allows to be taken into account for qualified retirement plans. At the current time, that limit is \$205,000. Thus, an owner whose compensation exceeds this level will have his or her compensation *capped* at the \$205,000 level. In the first stage of our formula, this HCE receives an allocation of 5 percent of compensation, just like all the other employees. So, 5 percent of \$205,000 would be \$10,250.

The maximum allocation of employer contributions in a defined-contribution plan that any plan participant can receive (this is the limit under IRC Section 415) is \$41,000 beginning in 2004. (A higher amount, \$3,000 in 2004 increasing to a maximum of \$5,000 in 2006, can be provided if a plan includes a 401(k) feature and the individual involved is age 50 or older; he is then eligible for the catch-up provisions provided under IRC Section 414(v).) Applying our second-level allocation formula, we subtract \$100,000 from \$205,000 to get an "excess compensation" amount of \$105,000. Our formula says that we calculate 100 percent of this amount, which would also be equal to \$105,000. Now, since the law provides an overall limit of \$41,000 (as noted above), we cannot actually allocate \$105,000. Instead, we are allowed to allocate only as much as would bring this participant up to the maximum allocation of \$41,000, in this case, an additional \$30,750.

As you can see, the second-level allocation formula is really just meant to maximize those participants whose income exceeds, in this example,

\$100,000. The integration level selected can be higher or lower, so long as the resulting allocation for the HCEs involved produces the maximum allocation under the law.

Once we have our allocations calculated for all the participants, we have to actually run our nondiscrimination testing to see if we pass all the required tests. If we do, it is great; if not, we will have to take corrective action to make sure that the plan does pass. (See the following sections.)

Individual Modifications

It is permissible to have different levels of contributions for different participants in the plan. For example, we might have a highly compensated salesperson who makes \$150,000 per year, but is not an owner of the business. It is quite possible that the owners do not want to provide a maximum retirement plan contribution to this individual, even though he is an HCE. We could add a provision to the plan formula that says the following:

Notwithstanding the plan's allocation formula above, Johnny Salesman will be limited to a maximum annual allocation in this plan of 5 percent of his compensation under the plan.

Such a provision would override the general formula, and the salesman would get just the 5-percent allocation provided by the first allocation level of the formula and nothing out of the second level. Since we are discriminating here *against* an HCE, we are allowed to do so. In fact, this will help in the passing of the overall nondiscrimination tests because the EBAR for this highly compensated individual will be significantly lower than what the EBAR would have been if he had received the maximum legal allocation. Thus, in our testing, the average for the HCEs will be lower, and it will be easier for the other HCEs (the owners in this case) to pass the nondiscrimination testing process.

This same type of limitation can be applied if children of the owners are covered under the plan. Under the attribution rules of IRC Section 318, a child of a more than 5-percent owner (one of the definitions of an HCE) is considered an HCE regardless of his or her actual compensation or ownership. Thus, because of familial relationships, a young, lower paid employee who happens to be a child of an HCE will be included in the HCE group for testing and could significantly adversely affect the testing results. To prevent this, we could limit the allocation to that child (via the language of the plan document) to a very small amount, including a zero allocation.

We might have the same situation with a spouse on the payroll who is taking a modest income. By giving that spouse a full allocation, we will generally be hurting the demographic testing of the plan. Therefore, by discriminating against that spouse (who by definition is also an HCE due to family attribution), we enhance our demographics for testing purposes and might end up saving many thousands of dollars that we might otherwise have to distribute to the NHCEs in order to pass the nondiscrimination tests.

Use of Allocation Groups in the Plan Design

Another method of providing larger contributions for our HCEs is to define specific allocation groups within the plan. For example, a physician group is looking for a plan design that will provide a greater share of allocations to the five shareholder physicians under the corporation's profit-sharing plan. Currently, the plan uses a safe-harbor permitted disparity formula and each doctor earns well in excess of \$200,000.

The plan is amended to create two allocation groups, namely, Group A and Group B. Group A consists of shareholders and Group B consists of all other participants (in this case, we have 10 eligible participants in Group B). The plan authorizes the employer to make separate discretionary contributions to each allocation group. When making a contribution, the employer must designate in writing how the contribution is to be divided between the two groups.

A total of \$235,000 is contributed by the corporation for the current plan year. The employer designates \$205,000 of the contribution for Group A (which is $5 \times \$41,000$ so that each doctor receives the maximum legal allocation) and the rest of the contribution for Group B. The \$30,000 contribution for the Group B employees equates to a contribution of 10 percent of their compensation (the total compensation for the 10 participants is \$300,000). The doctors did not have to provide this high a benefit, but that is what they wanted to provide to their employees. When we do the nondiscrimination testing, we find that we pass the tests with this 10-percent allocation to Group B.

Each Participant in His or Her Own Allocation Group

The division of participants in allocation groups can be taken to the logical conclusion, which is to place each and every participant in his or her own allocation group. Then, the employer can carefully determine (with the retirement plan consultant's help and guidance) how much will be allocated to each and every participant. Such a design is absolutely permissible, but it does require significant attention to detail. One particular issue that must be watched is the previously mentioned requirement that the employer must designate in writing how the contribution is to be divided between the multiple groups.

Benefits, Rights, and Features

It is important to note that there are other nondiscrimination rules in addition to the mathematical tests. Though we are not going to discuss them in depth, in addition to contributions or benefits having to be nondiscriminatory, the benefits, rights, and features provided by the plan must be available on a

nondiscriminatory basis.² Two additional availability tests must be satisfied, namely, a current availability test and an effective availability test. The details of these tests, which are beyond the scope of this chapter, once again point to the importance of having a competent plan adviser who is aware of these requirements.

We failed! What now?

If the contributions or benefits under the plan are discriminatory, or if the availability of benefits, rights, and features is discriminatory, corrective action must be taken (an amendment adopted) within 9½ months after the close of the plan year (e.g., October 15, following the end of a calendar plan year).

Corrective Amendment to the Rescue

A corrective amendment may increase contributions or benefits, or add participants, so that the plan can satisfy one of the safe-harbor tests available under the IRC Section 401(a)(4) regulations or so that the contributions or benefits can satisfy the rate group test described above.

A corrective amendment may not reduce accrued benefits to correct discrimination. Thus, it is not allowed to retroactively reduce the benefit even for an HCE so that the tests may be met. Such an amendment would violate the anti-cutback rules under IRC Section 411(d)(6) and is not permitted.

Amendment Subject to Testing on Its Own

In addition, the additional allocation in the amendment must itself be tested and must pass IRC Section 401(a)(4) on its own unless the plan is being amended so that it would pass one of the safe-harbor tests. If only NHCEs are being credited with additional contributions, then no testing is necessary since it would be impossible for such an amendment to fail the discrimination tests based on the numbers alone.

Amendment Must Have Substance

The amendment must have substance for the affected employees. If you were to provide that additional dollars are added to terminated NHCEs who are not vested, the amendment would be disregarded since no economic benefit would be received by the employee from such an amendment. Note that this is true, even though if that additional contribution had been part of the original allocation, the plan would have passed the nondiscrimination tests and the participant still would not have received the funds because he was zero-percent vested. If it is critical that the former employee's benefits be enhanced to pass the tests, then it is possible to include in the amendment a change to the vesting schedule such that the terminated participant is now entitled to a

² Treas. Reg. Section 1.401(a)(4)-4.

vested benefit of some amount. The IRS will want to make sure that the vested amount is of substance, so vesting the employee in, say, ten dollars probably would not fly. But providing a minimum vesting of, say, 10 percent of the account probably would be substantial enough, but it is a facts and circumstances determination subject to IRS discretion as to how they view it.

Miscellaneous Issues

A number of plans fall outside the usual concerns and testing about nondiscrimination. These include plans that benefit only NHCEs, and plans under which all employees are HCEs.

Plans That Cover Only NHCEs

A plan that benefits only NHCs is deemed to be nondiscriminatory because all the nondiscrimination tests look at whether we are discriminating *in favor of* HCEs. Thus, no matter how our allocation formula works, if no HCEs are benefiting, it is impossible to fail the rate group test because there are no rate groups to test! In addition, a plan that does not cover HCEs will be deemed to pass the coverage requirements of IRC Section 410(b). This concept of automatic passing of the nondiscrimination tests means that an employer has almost unlimited flexibility when designing a plan allocation formula if no HCEs are covered by the plan.

The law does not say that we cannot discriminate *in favor of* some NHCEs over other NHCEs. It likewise doesn't say we can't discriminate *against* HCEs. The specific prohibition is that we cannot impermissibly discriminate *in favor of* HCEs.

Plans That Cover Only HCEs

If an employer's entire work force consists of only HCEs, there is no one against whom discrimination could occur since there are no NHCEs. Since there is no possibility of discrimination against NHCEs, the plan would be deemed nondiscriminatory even though all of the participants are HCEs. Likewise, such a plan is deemed to pass the coverage requirements.

The same result would hold if the employer does have NHCEs, but all of the NHCEs are *otherwise excludable* such as they do not meet the minimum age and service requirements, or they are all union employees subject to collective bargaining.

Conclusion

The design of cross-tested plans is both an art and a science. The enormous complexity of the IRS regulations in this area provides both opportunities and pitfalls for the practitioner. The need to have competent assistance on an ini-

tial and ongoing basis cannot be overemphasized. Intelligent practitioners will recognize that they cannot afford to go it alone in this area. The risk of mistakes is high and the penalty can be catastrophic—both for the client and the practitioner.

The material presented in this chapter is far from a complete examination of this area and will *not* equip practitioners to design and administer these plans on their own. It is a wise individual who knows his or her limitations and calls in the artillery when appropriate.

Chapter 10

Defined-Benefit Plan Design

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Defined-Benefit Plan Design

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If we were to look at the number of defined-benefit plans in existence today versus 20 years ago, it would not be surprising to hear us say that defined-benefit plans are dead. Specifically, there are 80-percent fewer defined-benefit plans in place today than there were 20 years ago. It would not be hard for one to conclude that there is obviously something terribly wrong with these animals and anyone who is smart will stay away from them. Indeed, many accountants feel that way.

Why the decline? There are a number of reasons, primarily the following:

1. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)
2. The Tax Reform Act of 1986 (TRA 86)
3. The stock market runup of the 1980s and 1990s

The tax law changes because they decreased the maximum benefits payable and increased complexity, and the stock market run-up because, combined with the reduced benefit limits, many plans became fully funded or over-funded.

But are defined-benefit plans *really* dead? Or better yet, are they *still* dead? In a word, no.

Introduction

Over the past several years, there has been a revival of defined-benefit plans, particularly in the small employer arena, and even more so with the advent of cash-balance plans (to be discussed in more detail later in this chapter). There are several reasons for this resurgence, including:

1. The repeal of Internal Revenue Code (IRC or the Code) Section 415(e) by the Small Business Jobs Protection Act of 1996 (SBJPA)
2. The aging of the Baby-Boom generation, combined with this group's realization that it has not saved enough for retirement
3. The (perceived or not) ultimate demise of the Social Security system
4. Most recently, the increase in benefit limits brought about by the Economic Growth and Tax Reform and Reconciliation Act of 2001 (EG-TRRA)

So what *is* a defined-benefit plan? According to the Internal Revenue Code, a defined-benefit plan is "... any plan which is not a defined contribution plan." (See IRC Section 414(j).) To get a better answer, one must then look to the definition of defined-contribution plan, which is found one paragraph earlier in IRC Section 414. There, we see that a defined-contribution plan is a plan in which the benefit is based solely on amounts contributed to an individual's account and the actual earnings on such account. (See IRC Section 414(i).) In a nutshell, in a defined-benefit plan, the investment risk is borne by the plan sponsor, whereas, in a defined-contribution plan, the risk is borne by the participant.

Defined-benefit plans are not, of course, for everyone. As we have seen in previous chapters, up to \$40,000 (and even more with catch-up contributions) can be contributed annually to a defined contribution on an individual's behalf. In a majority of cases, this is ample retirement savings. However, for those with significant income, and certain other cases we will discuss, the defined-benefit plan makes sense.

Defined-benefit plans are certainly much more complex in nature than defined-contribution plans. For starters, an additional professional, an *enrolled actuary*, enters the picture. This individual is charged with determining the proper funding of the plan, as well as the proper payouts to terminating employees.

Also, defined-benefit plans are subject to minimum funding standards, standards which, if not met, can result in the imposition of excise taxes. (See IRC Section 4971.) That is, unlike a profit-sharing plan, for example, required contributions *must* be made. The secret is to manage required contributions and to use available mechanisms to reduce or eliminate them when necessary.

Finally, certain defined-benefit plans must purchase insurance coverage guaranteeing some or all benefits from a federal agency known as the Pension Benefit Guaranty Corporation (PBGC).

With this, we begin a discussion of some of the rules applicable to defined-benefit plans. The idea here is not to make the reader an expert; that would require an entire book larger than this one. The idea is to provide a general understanding of the utility of defined-benefit plans such that the reader will grasp when such a plan may be appropriate. Used properly, and in the right circumstances, a defined-benefit plan can be a very effective and useful tax and financial planning tool.

Benefit Limits

Under IRC Section 415(b), the annual benefit that can be provided by a defined-benefit plan cannot exceed the lesser of (1) \$160,000 (the dollar limit), or (2) 100 percent of the participant's average compensation for his or her high three years (the percentage of pay limit). In order for an individual to receive the full dollar limit, he or she must have at least 10 years of participation in the plan. In order for an individual to receive the full percentage of pay limit, he or she must have at least 10 years of service with the employer. (See IRC Section 415(b)(5).)

The dollar limit must be actuarially reduced where benefit begins *prior* to age 62. (See IRC Section 415(b)(2)(C).) The manner in which the reduction is made is set forth in Revenue Rulings 98-1 and 2001-51. The detail of such rulings is beyond the scope of this chapter, but an important factor is that the benefit limit is the lesser of that provided when reduction is performed using (1) the interest rate and mortality table set forth in the plan, and (2) the applicable mortality table (currently set forth in Revenue Ruling 2001-62) and 5 percent. If the maximum benefits are desired, the latter factors are, therefore, the same as the plan factors. Using 5 percent and the applicable mortality table, annual dollar limits are as follows:

Retirement Age	Benefit Limit
50	72,391
51	77,019
52	81,998
53	87,360
54	93,140
55	99,380
56	106,122
57	113,411
58	121,295
59	129,830
60	139,080
61	149,114
62	160,000

Similarly, if benefit payments are to begin after age 65, the benefit limit is actuarially increased under IRC Section 415(b)(1)(D). The limit is the lesser of that provided when reduction is performed using (1) the interest rate and

mortality table set forth in the plan, and (2) the applicable mortality table and 5 percent. Using the latter factors, annual dollar limits are as follows:

Retirement Age	Benefit Limit
65	160,000
66	172,226
67	185,533
68	200,054
69	215,969
70	233,457
71	252,745
72	274,050
73	297,577
74	323,630
75	352,543
76	384,680
77	420,458
78	460,157
79	504,224
80	553,159

If benefit payments are to begin anywhere from age 62 through age 65, the dollar limit is \$160,000. Note that the dollar limit is adjusted for inflation. (See IRC Section 415(d).) Beginning with plan years ending in 2004, the limit is \$165,000, such that the above amounts would be adjusted accordingly.

Average Compensation

Again, the percentage of pay limit is 100 percent of the participant's average compensation for his or her high three years. Under IRC Section 415(b)(3), a participant's high three years are the period of consecutive years (not more than three) during which the participant both was an active participant in the plan and had the highest aggregate compensation from the employer. The regulations however allow use of compensation earned during all service with the employer (Treasury Regulations Section 1.415-3(a)(3)), and the Internal Revenue Service (IRS) has consistently allowed use of such compensation in plan documents.

Example. Maria is the sole owner and sole employee of ABC Corporation. Before pension and salary, ABC has consistently earned \$75,000 to \$100,000. ABC has been in existence for five years, and, in each year, Maria has received a salary of \$50,000. ABC is considering the adoption of a defined-benefit plan on Maria's behalf. In order to fund the plan, ABC will have to reduce Maria's salary. Since Maria has three consecutive years at \$50,000, however, her average compensation for purposes of the percentage of pay limit would still be \$50,000.

All Defined-Benefit Plans of the Employer

When determining the above benefit limits, all defined-benefit plans of an employer (whether or not terminated) must be combined. For this purpose the employer includes any affiliated employer under IRC Sections 414(b), (c), (m), and (o).

Funding

The limits discussed in the preceding section are benefit limits. As accountants, we, of course, want to know the funding or deduction limit. That is, how much can the employer put in the plan? Basically, it is the amount needed to fund the benefits payable under the plan, with the benefits being subject to the limits previously discussed.

Actuarial Assumptions

As previously indicated, the required funding is determined by an enrolled actuary. In determining the amount of funding the actuary must use certain assumptions, known as *actuarial assumptions*. Under IRC Section 412(c)(3), the assumptions must be reasonable and must reflect the actuary's best estimate of anticipated experience under the plan. The following are some of the factors or assumptions that the actuary may take into account:

- Investment earnings of the fund prior to retirement (preretirement interest)
- Postretirement interest
- Pre- and postretirement mortality
- Employee turnover
- Salary increases
- Expenses
- Postretirement cost-of-living adjustments (COLAs)

In the small plan context, often the only assumptions considered are pre- and postretirement interest and postretirement mortality. For simplicity, these are the only assumptions that will be considered in the remainder of our discussion.

Funding Methods

In determining the amount of funding, in addition to funding assumptions, the actuary must also choose a funding method. (See Revenue Procedure 2000-40.) There are basically seven funding methods, as follows:

1. Unit credit (also called accrued benefit)
2. Individual spread gain (ISG, also called individual aggregate)
3. Aggregate
4. Entry age normal
5. Individual level premium
6. Attained age normal
7. Frozen initial liability

The author's experience has been that in the first two of the preceding small plan market methods, ISG are used most often. They are also the easiest to explain and our discussion will be limited to these methods.

Funding Standard Account

Under any funding method, the annual contribution requirement is the net of the charges (costs) and credits to the funding standard account (FSA). The most common charges to the FSA are:

1. Normal cost
2. Amortization charges
3. Interest on items 1 and 2

The most common credits to the FSA are:

1. Prior-year overpayment (credit balance)
2. Deposits to the plan
3. Amortization credits
4. Interest on items 1 to 3

Unit Credit Funding

Ordinarily, the *normal cost* is the most significant charge to the FSA. Under the unit credit funding method, the normal cost is the present value of the increase in the accrued benefit during the year. The *accrued benefit* is the portion of the participant's retirement benefit that has been earned at any point in time.

Example. ABC adopts a defined-benefit plan for Maria. Under the plan, Maria will receive an annual retirement benefit of \$5,000 for each year that she is a participant in the plan. Maria is currently age 55, and normal retire-

ment under the plan is age 65. Presuming she remains employed and the plan is not amended, Maria's accrued benefit will be \$5,000 at age 56, \$10,000 at age 57, \$15,000 at age 58, etc., until it reaches \$50,000 at age 65. In year one, therefore, the normal cost under the unit credit method of funding would be the present value, at age 56, of a \$5,000 annual payment, for life, beginning at age 65.

In order to determine the present value of the increase in the accrued benefit, we need to look at our actuarial assumptions. Previously, we indicated that we would constrain ourselves to pre- and postretirement interest and postretirement mortality (i.e., how long will payments continue after retirement). Preretirement interest represents the assumed earnings on plan assets prior to retirement. The combination of postretirement interest and postretirement mortality lead to the annuity purchase rate. The annuity purchase rate is the cost of an annuity, based on the age and gender of the contract owner and other factors; it is essentially the amount needed today to pay \$1 annually for the life of the participant.

Postretirement interest requires the selection of an interest rate, e.g., 5 percent. Basically, this means the interest that will be earned during the period of payout. Postretirement mortality requires the selection of a mortality table. There are a number of mortality tables in use today, but we will use the 1994 Group Annuity Reserving table projected to 2002 (the table set forth in Revenue Ruling 2001-62). At age 65, using a postretirement interest rate of 5 percent, this results in an annuity purchase rate of 12.252.

Example. Reconsider Maria and her plan at ABC. What's the normal cost in year one? Again, at the end of year one, Maria has earned the right to receive \$5,000 per year, for the rest of her life, beginning when she turns age 65. With an annuity purchase rate of 12.252, this means the plan will need to have \$62,160 when Maria turns 65. But this is nine years away, so the normal cost is the present value of \$62,160 due in nine years, discounted using the preretirement interest rate. Presuming the preretirement rate is also 5 percent, the normal cost at the end of year one is \$39,489. That is, \$39,489 deposited at the end of year one, earning 5 percent each year, will grow to \$62,160 at the end of year 10. This amount will then be available to provide Maria with \$5,000 per year for life.

Presuming she remains employed and the plan is not amended, Maria's accrued benefit will grow by another \$5,000 in year two. Accordingly, at the end of year two, she will have earned the right to receive \$10,000 annually, for the rest of her life, beginning when she turns age 65. The normal cost in year two is the present value of the \$5,000 increase in the accrued benefit. Again, the value at age 65 is \$62,160 (i.e., the annuity purchase rate of 12.252 times the \$5,000 increase in the accrued benefit). But the present value will be greater than it was in year one, since we are a year closer to retirement. Again, using a discount rate of 5 percent, but discounted this time for eight years, our present value, i.e., our normal cost, is \$41,463.

Actuarial Gains and Losses

What happens if (when) the plan does not earn 5 percent on year one's deposit? That is, it's a pretty good bet that the \$39,489 deposited at the end of year one will not be worth exactly 5 percent more at the end of year two. That is, with a preretirement interest rate of 5 percent, we have assumed that the deposit will grow by 5 percent each year such that at the end of year two, prior to year two's deposit, there will be $\$39,489 \times 1.05$ or \$41,463 in the plan. What if there's more or less?

The difference between the expected return and the actual return is referred to as an *actuarial gain* or *actuarial loss*. Presume that at the end of year two, there is only \$40,000 in the plan. There is an actuarial loss of \$1,463. What we do with this loss depends on the funding method we are using.

One of the characteristics of the unit credit funding method is that it is an immediate gain method. This means that each year's actuarial gain or loss is immediately recognized, and amortized over a certain period, generally five years. (See IRC Sections 412(b)(2)(B)(iv) and 412(b)(3)(B)(ii).) Other funding methods (including ISG) are what are called spread gain methods. This means that gains and losses are spread over the remaining working lives of the participants in the plan.

Example. At the end of year two, the ABC plan has assets of \$40,000. That is, the \$39,489 deposited at the end of year one did not grow by the assumed 5 percent to \$41,463. There is, therefore, an actuarial loss of \$1,463. This loss must be amortized over a five-year period at the preretirement interest rate used for funding. This is effectively the same as paying off a loan of \$1,463 over a five-year period. Accordingly, in addition to the normal cost for year two, an additional \$338 (an amortization charge) must be deposited.

What if there is \$42,000 instead of \$40,000? This means there is an actuarial gain of \$537 (\$42,000 less the expected \$41,463). This results in an amortization credit of \$124 for each of the next five years. This amount serves to reduce the otherwise required contribution for year two.

As the above demonstrates, unit credit funding closely tracks benefit accruals. That is, benefits are being funded as they are earned. If funding assumptions are similar to actuarial equivalence factors, payout amounts will coincide with accumulated funding. (See the following discussion of payment of benefits.) This makes unit credit a convenient funding method to use in a setting in which individual costs are being closely tracked and allocated to each individual, as is often the case in a professional setting.

Individual Spread Gain

Let's now look at how funding differs using ISG to fund the plan. Under this method, the full benefit expected at retirement is projected, and the normal cost is the level annual amount needed to accumulate the funds required to

provide this benefit. For this reason, ISG is often referred to as a level funding method.

Example. Assume that instead of using unit credit funding the ABC plan uses the ISG method. Recall that the plan provides for a benefit of \$5,000 for each year of participation in the plan. Maria enters the plan at age 55, and the plan's normal retirement age is 65. She is, therefore, projected to have 10 years of participation in the plan, such that her projected benefit is \$50,000. Again, using an annuity purchase rate of 12.252, this means that the plan will need \$612,600 at the end of 10 years to provide this projected benefit. The normal cost is then the level amount needed to reach this amount at the end of 10 years.

How is this amount determined? First, we compute the present value. The present value is \$612,600 discounted back nine years (as we are performing this valuation at the end of year one). Continuing to use 5 percent, our present value is \$394,887. Again, this can be equated to a loan of this amount, with a repayment period of 10 years. The result is an annual payment, or normal cost, of \$48,705.

As indicated above, the difference between the actual and projected investment gain or loss is referred to as an actuarial gain or loss. Under ISG, such gain or loss is spread over the remaining working lives of the plan participants. The manner in which this is done is set forth in the following example:

Example. At the end of year two, the ABC plan has assets of \$50,000. That is, the \$48,705 deposited at the end of year one did not grow by the assumed 5 percent to \$51,140. There is, therefore, an actuarial loss of \$1,140. Since the plan is using ISG for funding, there is no amortization charge. Instead, the loss is effectively folded into the normal cost going forward.

Presuming she remains employed and the plan is not amended, Maria's projected benefit remains at \$50,000 in year two. Again, we begin by computing the present value of the projected benefit. The present value is \$612,600 discounted back eight years now, or \$414,632. But we now have assets. These assets are subtracted from the present value of the projected benefit to arrive at the "present value of future normal costs."

Accordingly, the \$50,000 of assets is subtracted from the \$414,632 present value to arrive at a present value of future normal cost totaling \$364,632. The normal cost is then equated to the payments on a loan of this amount over a period of nine years. The result is an annual payment, or normal cost, of \$48,857.

Note that the normal cost in year two is slightly higher than that in year one. The reason is the spreading of the actuarial loss. If the plan instead earned the assumed 5 percent each year, the normal cost, and annual funding,

of the plan would remain constant over the 10 years to retirement (presuming that the projected benefit did not change).

Contrast this to the funding pattern under the unit credit method. Recall from above that the normal cost in year two was 5 percent higher than that in year one. This was due to the fact that the normal cost under such method is the present value of the increase in the accrued benefit. All things being equal, the present value of something in year two will be higher than the present value of the same amount in year one by a factor of the interest rate being used. If the normal cost is projected to remain at \$48,705 where all assumptions were met under the ISG method, the normal cost (and annual funding if all assumptions are met) under the unit credit method would look like this:

Year	Normal Cost
1	\$39,489
2	41,463
3	43,536
4	45,713
5	47,999
6	50,399
7	52,919
8	55,565
9	58,343
10	61,260

Note that the same number of dollars will be accumulated. ISG simply provides for funding on a level basis where the unit credit method provides for steadily increasing funding. There is no right way or wrong way. The choice of funding method is based on a number of facts and circumstances, some of which will be addressed later in this chapter.

Let's add some zeros to our numbers. That is, we have been working with a relatively modest plan for a very small company. We have also been working with a single participant and a flat dollar (as opposed to percentage of pay) benefit formula. Let's add an employee, and blow the numbers up a bit.

Recall from above that the maximum benefit that Maria can receive is the lesser of the dollar limit or the percentage of pay limit. Presuming retirement is age 62 or later and the year is 2003, the former is \$160,000 (reduced if there are less than 10 years of plan participation when payments commence) and the latter is 100 percent of average compensation for the participant's high three consecutive years (reduced if there have been fewer than ten years of service with the employer when payments commence).

Example. Let's assume that Maria's compensation has consistently been \$200,000 per year instead of \$50,000. Also, assume there is another employee of ABC, John, who is 35 years old and has consistently earned \$35,000 annually. ABC wishes to adopt a plan to maximize Maria's benefit. Staying with a retirement age of 65, Maria will have 10 years of participation in the plan, such that her dollar limit will be \$160,000. Her percentage of pay limit will be \$200,000. The maximum benefit is the lesser of the two, or \$160,000.

\$160,000 represents 80 percent of Maria's pay. Since Maria will be in the plan for 10 years, we will set the plan's benefit formula to provide for a retirement benefit of 8 percent of compensation for each year of participation in the plan, up to a maximum of 10 years.

We first look at unit credit funding. At the end of year one, Maria has an accrued benefit of \$16,000 (\$200,000 times 8 percent), and John has an accrued benefit of \$2,800 (\$35,000 times 8 percent). Each of these amounts is payable annually for the participant's life beginning at age 65. First-year normal costs for the two participants are as follows:

	Maria	John
Increase in accrued benefit	\$16,000	\$2,800
Annuity purchase rate at age 65	12.252	12.252
Future value of increase	196,032	34,306
Years to retirement (end of year)	9	29
Discount factor at 5%	.64461	.24295
Normal cost	126,364	8,335

In order to determine the normal cost using ISG, we must first determine the projected benefit for each participant. We then determine the present value of this projected benefit and our normal cost is the level amount needed to pay this loan.

Example. Maria's projected benefit is \$160,000 (\$200,000 times 8 percent times 10 years) and John's is \$28,000 (\$35,000 times 8 percent times 10 years). Using ISG, normal costs are as follows:

	Maria	John
Projected benefit	\$160,000	\$28,000
Annuity purchase rate at age 65	12.252	12.252
Future value of projected benefit	1,960,320	343,056
Years to retirement (end of year)	9	29
Discount factor at 5%	.64461	.24295
Present value of future normal cost	1,263,640	83,344
Normal cost	155,854	5,163

Compared to unit credit funding, you will notice that Maria's normal cost increases while John's decreases. This is due to the funding period versus the accrual period, the latter being the period over which the benefit is earned, or accrued. Maria is projected to be a participant in the plan for 10 years, from age 55 to age 65, the same number of years during which she is earning her benefit. John, on the other hand, is projected to be a participant in the plan for 30 years. His benefit will be earned, however, over the first 10 years (although in later years his benefit will increase if his pay continues to increase).

Conversely, when using the unit credit method, funding is done over the period in which the benefit is earned. Under ISG conversely, funding is done over the participant's entire working life. So, all things being equal, and ignoring actuarial gains and losses as well as salary increases, the normal cost (and contribution to the plan) for John would be \$5,163 each year for 30 years, using ISG. With the same assumptions, using unit credit funding, the annual normal costs would be as follows:

John's Age End of Year	Normal Cost
36	\$ 8,335
37	8,752
38	9,190
39	9,650
40	10,133
41	10,640
42	11,172
43	11,731
44	12,318
45	12,934

Play with a spreadsheet a bit, and you will see that depositing the above numbers for 10 years, and then nothing for the next 20 years, will grow to the same \$343,056 as \$5,163 for 30 years, assuming a 5-percent annual rate of return in each case. Any slight difference will be due to rounding.

Recall that under the unit credit funding method, the difference between our projected investment return and our actual investment return is an actuarial gain or loss that is amortized over a five-year period. We also said that under ISG, that such gain or loss is spread over the remaining working lives of the plan participants. In a one participant plan this is easy; it is the life of the single participant. But how is this done if there is more than one participant?

Allocating Assets in Individual Spread Gain

Under ISG, the assets are actually allocated among the participants each year. Note that this allocation is for funding only and has nothing to do with account balances or anything else. The allocation of the assets is proportionate based on each participant's allocation basis, the sum of the participant's prior normal costs, accumulated with interest. Effectively, it is the sum of the amounts that have been deposited for the participant in each previous year, accumulated with interest at the rate used for funding.

Example. Using ISG, the normal cost in year one for the ABC plan was \$161,017 (\$155,854 for Maria and \$5,163 for John). If the plan earned exactly 5 percent, there would be assets of \$169,068 at the end of year two, or \$163,647 for Maria and \$5,421 for John. These amounts become their allocation basis for purposes of allocating the actual assets at the end of year two.

Assume assets at that time are actually \$165,000. This amount is allocated proportionally to Maria and John based on their allocation basis, such that \$159,709 is allocated to Maria and \$5,291 is allocated to John. Assuming no change in wages or benefits, normal costs for year two are as follows:

	Maria	John
Projected benefit	\$160,000	\$28,000
Annuity purchase rate at age 65	12.252	12.252
Future value of projected benefit	1,960,320	343,056
Years to retirement (end of year)	8	28
Discount factor at 5%	.67684	.25509
Present value of projected benefit	1,326,823	87,510
Allocated assets	159,709	5,291
Present value of future NC	1,167,114	82,219
Normal cost	156,382	5,172

Note that future COLAs cannot be assumed when funding for a participant at the dollar limit. Recall from above that the dollar limit increased from \$160,000 to \$165,000 in 2004. This increase was announced by the IRS via Information Release 2003—122 on October 16, 2003, ample time for determining 2003 funding. Nevertheless, when funding a calendar 2003 plan, the largest benefit that the actuary could presume for funding purposes would be \$160,000 (adjusted for before age 62 or after age 65 retirement), notwithstanding that the actuary knows that the benefit will be at least \$165,000 annually. (See Treasury Regulations Section 1.412(c)(3)-1(d)(1)(i) and Revenue Ruling 81-195.) However, if the plan year ended on January 31, 2004, for ex-

ample, it would be appropriate to consider the higher limit. (See Revenue Ruling 81-215).

Payment of Benefits

Minimum Lump Sums

Most small plan benefits are paid in the form of a lump sum. That is, most employees do not actually end up receiving an annuity for life. Instead, they elect to receive the present value of their benefit in the form of a lump sum. The amount of the lump sum is the actuarial equivalent of the life annuity. In this section, we will discuss how this amount is determined.

Example. Two years after commencing participation in the ABC plan, John terminated his employment with ABC at age 37. At the time, John's accrued benefit was \$5,600 (two years at \$2,800). This means that beginning in 28 years (when he reaches age 65), John has the right to receive \$5,600 annually for life. If the employer is a large public company, with a human resources department that tracks terminated employees, this may make sense. For ABC, it is more feasible to just to pay John off and make him go away. Of course, that is probably John's preference too.

Actuarial equivalence is really a fancy way of saying present value. It is the single-sum current value of a stream of payments otherwise payable now or in the future. Just as in funding, in order to determine actuarial equivalence for payouts, we need to use actuarial assumptions. But here, the actuary's discretion goes away. That is, the assumptions used must be stated in the plan (IRC Section 401(a)(25)), and the payout amount must be the greater of (1) that determined using the assumptions set forth in the plan, and (2) that using the applicable interest rate and the applicable mortality table. (See IRC Section 417(e)(3).)

Applicable Interest Rate

Pursuant to IRC Section 417(e)(3)(A)(ii)(II), the *applicable interest rate* is the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. If we actually used the month before the date of distribution, we would constantly be revising our numbers. That is, the time between notification to the employee and actual payout often takes a number of months. If the employee is notified that he or she has a benefit coming, you must tell him or her the amount of the lump sum. Actual distribution, however, will occur some number of months in the future. If we were forced to use the rate for the month before distribution, the actual distribution would be some amount other than what the employee was previously told. This is due to the fact that the interest rate, and, therefore, the present value of the future annuity stream, will be different.

To alleviate this problem, the IRS published regulations under IRC Section 417(e). In these regulations, the IRS allows us to choose (*in the plan document*) a stability period and a look-back month. The *stability period*, the period during which the applicable interest rate remains unchanged for purposes of payout calculations, can be from one to 12 months. The *look-back month*, the period prior to the start of the stability period from which the rate is chosen, can be anywhere from zero to five months.

Example. The ABC plan provides for a stability period of 12 months (the calendar year). For a given calendar year, this means that the rate stays the same for the entire year. Additionally, the plan states that the look-back month is the second month preceding the start of the stability period. This means that the rate for a given calendar year will be the rate for November of the preceding year. Accordingly, if a participant receives notice in May that his or her payout will be a certain amount when paid in July, this amount will be the same in July; it will *not* change due to use of the July rate versus the May rate.

The IRS publishes the applicable interest rate each month. For example, in Notice 2002-80, the IRS announced that the rate for November 2002 was 4.96 percent. Accordingly, for all of 2003, the ABC plan would use 4.96 percent as the applicable interest rate when determining payouts. As previously mentioned, however, when making payouts, the employee must actually receive the greater of (1) the value using the applicable interest rate and applicable mortality table, the IRC Section 417(e) minimum; or (2) the value using the interest rate and mortality table set forth in the plan.

Example. Recall from above that John terminated employment after two years in the ABC plan with an accrued benefit of \$5,600. John was age 37 at the time of his termination, 28 years from the plan's retirement age. For actuarial equivalence purposes, the plan's interest rate is 5 percent and its mortality table is the applicable mortality table. Again, these factors must be specified in the plan. The annual percentage rate at 65 using these factors is 12.252. Presuming the payout is taking place in 2003, the applicable interest rate is 4.96 percent. At age 65, using this rate and the applicable mortality table, the APR is 12.292. John's payout amount is \$17,748, determined as follows:

	Plan Rates	417(e) Minimum
Accrued benefit	\$ 5,600	\$ 5,600
APR age 65	12.252	12.292
Value at age 65	68,611	68,835
Years to age 65	28	28
Interest rate	5%	4.96%
Discount factor	.25509	.25783
Present value	17,502	17,748

It is apparent from the above and mathematically obvious, that the lower the interest rate, the greater the lump-sum payment. A smart accountant might look at this and determine that, in a one-participant, owner-only plan, if the goal is to shelter as much as possible, it behooves us to have the plan rates extremely low. Before finding that one cannot be this aggressive, look at the following example of what is being said here.

Example. Assume once again that Maria is the only participant in the ABC plan. Also, assume that her annual earnings were \$200,000 for a number of years prior to the plan's inception, high enough that her benefit limit is the dollar limit, which is assumed to be \$165,000. The plan's actuarial equivalence factors are 1 percent interest and the applicable mortality table. Assume the same 417(e) rates set forth above. At age 65, Maria's number would look like this (the last column is explained below):

	Plan Rates 1 Percent	417(e) Minimum	Plan Rates 5 Percent
Accrued benefit	\$ 165,000	\$ 165,000	\$ 165,000
APR age 65	17.787	12.292	12.252
Value at age 65	2,934,855	2,028,180	2,021,580

Maximum Lump Sums

Absent some override to the rules under IRC Section 417(e), Maria's lump sum would indeed be just under \$3 million if the plan's interest rate for actuarial equivalence was 1 percent. We find our override in the first sentence of Treasury Regulations Section 1.417(e)-1(d)(1), which states that the above requirements are subject to the limits under IRC Section 415.

IRC Section 415(b)(1)(E) sets forth limits governing the assumptions that can be used when converting the dollar limit or percentage of pay limit (the IRC Section 415(b) limit) to a lump sum, and extensive guidance is provided in Revenue Ruling 98-1. Under Revenue Ruling 98-1, the maximum lump sum is the lesser of the actuarial equivalent of the IRC Section 415(b) limit using (1) plan rates or (2) the applicable mortality table and the applicable interest rate (i.e., the 417(e) minimum).

Example. If the plan's factors are 1 percent and the applicable mortality table, Maria's maximum lump sum cannot exceed \$2,028,180. If, on the other hand, the plan's factors were 5 percent and the applicable mortality table, Maria's lump sum could not exceed \$2,021,580, the last column in the example above.

Early Termination Rule

With certain exceptions, Treasury Regulation Section 1.401(a)(4)-5(b)(3) contains a limitation on the payout of lump sums to certain employees. This rule

effectively limits the payments in any given year to a restricted employee to an amount that is equivalent in value to the annual payment of the individual's accrued benefit.

A *restricted employee* is an HCE or former HCE who is one of the 25 employees (or former employees) of the employer with the largest amount of compensation in the current or any prior year. An employee is an HCE if (1) during the current or prior plan year, he or she is or was a more than 5-percent owner of the employer (considering the attribution rules of IRC Section 318(a)), or (2) during the prior plan year earned more than \$90,000 (indexed). An employer may make a top-paid group election limiting the number of employees who are classified as HCEs, under the compensation rule, to 20 percent of the work force. (See IRC Section 414(q).)

Under the regulations the restriction does not apply in the following cases:

1. After the distribution, the plan has assets adequate to cover 110 percent of an amount basically equivalent to its termination liabilities.
2. The amount of the distribution is less than 1 percent of the liabilities under the plan.
3. The distribution is less than \$5,000.

In addition to the aforementioned exceptions, the IRS will allow for an immediate lump-sum distribution under which adequate security is provided to the plan. The requirements for such security are set forth in Revenue Ruling 92-76. The Ruling provides that a lump sum may be paid if one of three types of security are provided:

1. Assets equal to 125 percent of the lump sum are kept in escrow and pledged to the plan. This might be done by rolling the distribution to an individual retirement account or annuity (IRA) that, with existing balances, would equal or exceed the 125-percent requirement. The 125-percent threshold is of the restricted amount. The *restricted amount* is the excess of the lump-sum payment over the accumulated amount that could have been taken under the life annuity, both increased with interest. If the value of the account decreased such that the assets were less than 110 percent of the restricted amount, additional assets would need to be added to the escrow account.
2. A bond is posted, equal to 100 percent of the restricted amount.
3. A bank letter of credit is issued in the amount of the restricted amount.

Under the security agreement, all or a portion of the distribution would be repayable to the plan in an amount necessary to allow the plan to pay its liabilities upon termination. This might occur if the plan were to terminate at a time when the employer was not able to fully fund the plan such that the remaining participants might receive less than 100 percent of the value of their

benefits. In such a case, the IRS wants to ensure that HCEs are not allowed to receive 100 percent of their funds while others receive something less.

Example. Maria has reached the ABC plan's normal retirement age of 65. Her accrued benefit is \$165,000, with a lump-sum equivalent of \$2,021,580. There are other participants in the plan, however, and payment of the lump sum to Maria will cause the plan to fail the necessary funding requirements. Absent an adequate security arrangement, the maximum amount that Maria can receive from the plan during the year is \$165,000.

Adjustments to Funding

There is a common misconception that once a defined-benefit plan is put into place the employer is "stuck" with a funding level similar to that in the first year. This is not the case. There are tools that the actuary and the plan sponsor have available to reduce future funding obligations when circumstances warrant.

Reducing Future Benefits

One way in which funding can be reduced is by reducing future benefit accruals. In cases in which funding is based on the projected benefit (e.g., ISG funding is being used), this approach can often be used even after the end of the plan year.

Example. Maria and John are participants in ABC's defined-benefit plan, with (current and average) compensation of \$200,000 and \$35,000 respectively. The plan's benefit formula is 8 percent of average compensation per year of participation up to a maximum of 10 years. As computed above, year one's normal cost is \$161,017 (\$155,854 for Maria and \$5,163 for John), based on projected benefits of \$160,000 and \$28,000 for Maria and John, respectively. Two months into year three, ABC realizes that it will not be able to fund anywhere near \$161,017 for year two due to a significant reduction in cash flow. Is there anything that can be done?

IRC Section 411(d)(6) prohibits the reduction of a benefit that has been accrued. That is, at some point during a given plan year, the plan's participants earn the right to receive the benefit that accrues during that plan year. Often, this occurs when they have achieved 1000 hours of service. Once this threshold is crossed, the benefit that has been earned cannot be amended away.

But this does not mean that *future* benefits cannot be reduced, or even eliminated altogether. Additionally, IRC Section 412(c)(8) provides that, when determining funding for a given year, amendments made up to 2½ months after the end of the plan year may be taken into account.

Example. ABC wishes to reduce funding for year two and future years. As of the end of year two, Maria and John had accrued benefits as follows:

	Maria	John
Average compensation	\$200,000	\$35,000
Accrual rate per year	8%	8%
Accrual years to date	2	2
Accrued benefit	32,000	5,600

In February of year three, ABC adopts an amendment to the plan changing the maximum accrual years from 10 to two. Maria and John's projected benefits are, therefore, equal to their accrued benefits. Presuming assets of \$165,000, the funding obligation for year two is now \$14,925, as follows:

Projected benefit	\$ 32,000	\$ 5,600
Annuity purchase rate at age 65	12.252	12.252
Future value of increase	392,064	68,611
Years to retirement (end of year)	8	28
Discount factor at 5%	.67684	.25509
Present value of projected benefit	265,364	17,502
Allocated assets	159,709	5,291
Present value of future normal cost	105,655	12,211
Normal cost	14,157	768

Changing Funding Method

Note that it takes a projected benefit method to achieve this result. That is, if the plan is being funded using the unit credit method, the year two normal cost is based on the increase in the accrued benefit occurring during year two. An amendment reducing future benefits would, therefore, have no effect on year two funding. To reduce year two's funding in such a case, it would be necessary to amend the plan before the year two benefit was earned (e.g., before the participants worked 1000 hours in year two). Alternatively, the funding method could be changed.

Example. Assume the same situation as in the previous example except that ABC used unit credit funding in year one. In February of year three, it is too late to reduced the funding obligation for year two if the unit credit method is used. However, presuming the requirements to change the funding

method are met, a change to ISG for year two could accomplish a result similar to that in the previous example.

Revenue Procedure 2000-40 sets forth a relatively liberal set of rules for changing funding methods without IRS approval. Although a detailed discussion of the specifics of the Revenue Procedure is beyond our scope here, a change in the overall funding method to ISG is always available if the plan has not changed its funding method in the past five years. Revenue Procedure 2000-41 sets forth rules whereby a change in method can be requested where the automatic rules are not met. But in most situations, automatic approval is available.

ERISA 204(h) Notice

Whenever a plan amendment reducing future benefit levels is adopted, employees must be given advance notice. Section 204(h) of ERISA provides that the notice must be provided within a reasonable period of time before the amendment is effective. Failure to meet the requirements of ERISA 204(h) can result in plan participants being entitled to the higher of benefits with or without the plan amendment.

Parallel rules to ERISA Section 204(h) are provided in IRC Section 4980F. Under this IRC section, the failure to provide proper notice can result in penalties of \$100 per day. Regulations issued under IRC Section 4980F (Regulation Section 54.4980F-1) govern both ERISA Section 204(h) and IRC Section 4980F. Q&A 9 of these regulations provides that the IRC Section 204(h) notice must be provided at least 15 days prior to the date the amendment becomes effective (45 days in the case of a plan with 100 or more participants).

An IRC Section 204(h) notice is not required for a plan under which no employees are participants covered under the plan, as described in ERISA Regulation Section 2510.3-3(b). Generally, under this section, a plan must cover at least one employee. For this purpose, an individual and his or her spouse shall not be deemed to be employees with respect to a trade or business (whether incorporated or unincorporated), which is wholly owned by the individual or by the individual and his or her spouse. Also, a partner in a partnership and his or her spouse shall not be deemed to be employees with respect to the partnership. A plan that covers no one other than such a person (or persons) is deemed not to be an employee pension-benefit plan under ERISA and is not required to issue an IRC Section 204(h) notice if future benefits are being reduced.

Increasing Funding

Note that the ability to amend the plan up to 2½ months after the end of the plan year can also serve to increase funding. That is, if a plan is currently not providing for maximum benefits, and it is discovered after the end of the plan year that increased funding is desirable (e.g., profits are greater than expected and there is a tax problem), an amendment increasing benefits can be adopted

within the 2½-month period and can be considered in funding for the year just ended.

Other Issues Related to Adjusting Funding

Previously, plan amendments as well as funding method changes as a way to control funding levels have been discussed. These two approaches certainly can have the biggest impact on funding.

Another possibility is a change in funding assumptions. Sometimes, the actuary can look at the facts and circumstances and determine that a higher (or lower) assumed rate of return is possible. Additionally, factors like assumed retirement ages can be adjusted. The point is that, at least to a certain extent, things can be done to control funding obligations. The important thing is that communication takes place between the plan sponsor (i.e., employer) and the appropriate advisers (actuary, CPA, tax attorney, etc.).

Minimum Participation

Besides meeting the minimum coverage and nondiscrimination rules applicable to all plans, defined-benefit plans are subject to a special set of rules under IRC Section 401(a)(26). Under this section, a defined-benefit plan generally must cover the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of the employer's nonexcludable employees or (b) 2 employees. If there is only one nonexcludable employee, then the plan need not meet the two-employee minimum.

Nonexcludable employees are generally those employees who are not excludable under IRC Sections 410(b)(3) and 410(b)(4)(A). Excludable employees include (1) nonresident aliens with no U.S. source income; (2) union employees in which retirement benefits have been the subject of good-faith bargaining; and (3) employees who have not met minimum age and service requirements (generally 12 months of service and the attainment of age 21, but in certain cases 24 months of service and the attainment of age 21).

Pension Benefit Guaranty Corporation

Under Title IV of ERISA, certain defined-benefit plans must purchase termination insurance coverage from the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a federal corporation, created by ERISA to encourage the continuation and maintenance of defined-benefit pension plans. The PBGC protects the retirement incomes of nearly 44.3 million American workers in more than 31,000 private defined-benefit pension plans.

PBGC coverage provides benefits to participants of covered plans in which assets are insufficient to do so (up to a maximum). The maximum benefit the PBGC will guarantee is \$44,386 for 2004. The current annual premium for PBGC covered plans is \$19 per participant, with an additional "variable rate premium" for plans that do not meet certain funding levels.

Under ERISA Section 4021(b), certain plans are excluded from PBGC coverage. Noncovered plans include the following:

1. Defined-contribution plans
2. Plans covering only substantial owners (The term *substantial owner* is defined in Section 4022(b)(6) of ERISA, generally, as one who owns (or has owned within the last 60 months) at least 10 percent of a trade or business, whether or not incorporated. In determining ownership the constructive ownership rules of IRC Section 1563(e) apply.)
3. Plans established and maintained by a professional service employer which does not *at any time* have more than 25 active participants (It is under this exception that small medical, dental, and other professional practices escape PBGC coverage.)
4. Unfunded deferred compensation plans maintained primarily for the purpose of providing deferred compensation for a select group of management or HCEs (often referred to as top-hat plans or nonqualified deferred compensation plans)
5. Excess benefit plans (nonqualified plans maintained to provide benefits in excess of the limits of IRC Section 415(b))
6. Church plans in which no election has been made to be covered by ERISA
7. Most government plans
8. Plans that are fully funded by employee contributions
9. Plans established outside the United States for nonresident alien employees

Defined-Benefit Plan Termination

Upon termination of a defined-benefit plan, the remaining participants become 100-percent vested to the extent the plan is funded at such time. (See IRC Section 411(d)(3).) If the plan is subject to coverage by the PBGC, participants must be notified at least 60 days prior to the termination of the intent to terminate the plan. (See ERISA Section 4041(a)(2).) In a non-PBGC plan, the notification period is effectively the 15- or 45-day period required under ERISA Section 204(h) discussed above.

Additionally, in the case of a PBGC-covered plan, the plan assets must be sufficient to meet the plan's liabilities. Basically, this means that the plan must be able to pay out to each participant the lump sums required under IRC Section 417(e). If assets are insufficient at the time, the employer will need to make up the deficiency by making additional deposits into the plan. (See ERISA Section 4041(b)(1)(D), ERISA Regulation Section 4041.28(a)(1).)

Majority Owner Waiver

In certain circumstances, the requirement to make the plan sufficient can be satisfied by a *majority owner waiver*. (See ERISA Regulation Section 4041.21(b)(2).) A majority owner is a 50-percent or more owner of the plan sponsor. Ownership is determined, taking into account the constructive ownership rules of IRCC Sections 414(b) and (c). Such a waiver results in the majority owner foregoing the receipt of his or her plan benefits to the extent necessary to enable the plan to satisfy all other plan benefits. In order to be valid the majority owner's spouse must consent to the waiver of benefits.

Example. Maria owns 100 percent of ABC. The ABC defined-benefit plan is terminated at a time when the present value of Maria's accrued benefit is \$500,000, and the present value of John's accrued benefit is \$50,000. There is a total of \$450,000 of assets in the plan. There are two choices here. ABC can contribute the amount needed to fully pay Maria and John (\$100,000). Alternatively, Maria, with her spouse's consent if she is married, can sign a majority owner waiver, agreeing to take a lesser amount (i.e., \$400,000 instead of the \$500,000 present value of her benefit).

It is important to note that a plan sponsor that has no majority owners may not use the majority owner waiver to reduce the obligation to fully fund the plan at termination.

Example. Assume that ABC is equally owned by Maria and two other individuals who are not actively involved in the operation. ABC would have no choice but to fully fund the \$100,000 shortfall. Since Maria is not a majority owner, she could not elect to forego a portion of her benefit.

In the case discussed above, the PBGC-covered plan is able to meet its liabilities to the satisfaction of the PBGC. That means all benefit liabilities are met, or all benefit liabilities are deemed to be met via a majority owner waiver. If a plan terminates in satisfaction of this requirement, it is known as a standard termination, meaning that the PBGC is basically uninvolved.

If this is *not* the case, the PBGC gets involved and a distress termination ensues. This is a complicated, unpleasant set of events, likely resulting in the PBGC at least placing a lien on the plan sponsor's assets. See ERISA Section 4041(c) and ERISA Regulation Section 4041.41.

Cash-Balance Plans

We have previously determined that in a defined-contribution plan, a separate accounting is maintained for each employee and each year the account is credited with the actual contribution and actual earnings. That is, the contribution is what is defined and limited to the lesser of \$40,000 or 100 percent of compensation.

Conversely, in a defined-benefit plan, the plan determines what will come out at the end. That is, the benefit is what is defined. An actuary then determines the annual amount that must be deposited into the plan to provide such benefits. In addition to the benefits, the actuary takes into account an expected rate of return, in addition to other factors (e.g., mortality) when determining the required contribution. The actual investment results serve to cause the required contribution to increase or decrease over time based on whether or not they exceed projected returns.

In a traditional defined-benefit plan, a participant will receive a retirement benefit defined as some percentage of pay or some flat dollar amount. For example, a plan might provide for a benefit of 2 percent of pay for each year of participation in the plan. A participant with 25 years of participation would, therefore, retire at 50 percent of pay. Alternatively, a defined-benefit plan might provide for a monthly retirement benefit of \$50 for each year of service with the employer. A participant with 20 years of service would then receive a retirement benefit of \$1,000 per month.

As discussed above, there is no maximum contribution that can be made to a defined-benefit plan, *per se*. Instead, from our discussion above, we learned that the ultimate amount that comes out at the end is limited.

A cash-balance plan is a hybrid between a defined-contribution plan and a defined-benefit plan. It is a defined-benefit plan that looks (to the participant) like a defined-contribution plan. Legally, it is a defined-benefit plan since it does not meet the definition of a defined-contribution plan. That is, it is not a plan in which the benefit is based solely on amounts contributed to an individual's account and the actual earnings on such account. Therefore, the defined-benefit limits apply, i.e., the annual contribution on behalf of any participant is *not* limited to \$40,000. Instead, the ultimate retirement benefit cannot exceed the defined-benefit limits under IRC Section 415(b) indicated above (i.e., the lesser of the dollar limit or the percentage of pay limit).

In a cash-balance plan, a hypothetical account is maintained on behalf of each participant. On an annual basis, this account is credited with a contribution credit and an earnings credit. The contribution credit can be a flat dollar amount or a percentage of pay and can vary by employee. Again, the contribution credit is not limited to the annual defined-contribution limits.

The earnings credit is often (but not always) based on the applicable interest rate set forth under IRC Section 417(e). The plan is a defined-benefit plan because the contribution credit and the earnings credit are guaranteed to the employee, i.e., the amount that the employee will receive at retirement is defined. If the plan earns more or less than the earnings credit, future contributions are modified.

It is dangerous to provide for an earnings credit other than an IRS prescribed rate (a listing of prescribed rates can be found in IRS Notice 96-8). This is due to what is referred to as the whipsaw effect. As indicated above, a cash-balance plan is a defined-benefit plan. IRC section 417(e) says that when cashing out defined-benefit plan participants, the lump-sum cash out at any

age must be the present value of the amount payable at retirement age (generally age 65).

When determining the amount payable at retirement, the benefit earned to date (i.e., the current hypothetical account balance) must be projected out to retirement based on the plan's interest crediting rate. As we learned above in our discussion of minimum lump sums, however, our lump sum cannot be less than the present value using the applicable interest rate.

Example. Assume a plan credits participants' hypothetical accounts with an earnings credit of 8 percent each year. Further assume that the applicable interest rate is 5.5 percent and that retirement age under the plan is 65. Consider a 35-year-old participant who has a hypothetical account balance of \$2,500. At 8 percent, \$2,500 will grow to \$25,157 at age 65 (this assumes no further contributions, just the interest at 8 percent on the \$2,500). To cash this person out at age 35, they must be paid the present value of this amount. If determining the present value, however, we must discount back at the applicable interest rate. \$25,157 discounted back 30 years at 5.5 percent is \$5,048. The difference in the interest rate effectively doubles this person's payout amount. This phenomenon—that results when the lump-sum calculation is greater than the current cash balance account value—is known as the *whipsaw effect*.

Contrast this to a plan that credits interest at the prescribed interest rate. At 5.5 percent, the \$2,500 will be worth \$12,460 in 30 years. Discounted back at 5.5 percent, the present value is \$2,500. This is the case because we are projecting forward and discounting back at the same rate. Accordingly, the safest route clearly is to credit interest at the applicable interest rate.

In the following section, we will see how a cash-balance plan can work well in a professional setting.

Case Study

In this section, we will bring some of the preceding discussion of funding methods and cash-balance plans together while considering alternative plan designs for a professional corporation we will refer to simply as PC. For our purpose, we will assume there are six equal shareholders in PC and that they are the only employees. PC has never had a defined-benefit plan. The census for PC looks as follows:

	Age	Earnings
Shareholder 1	60	\$200,000
Shareholder 2	55	\$200,000
Shareholder 3	52	\$200,000
Shareholder 4	50	\$200,000
Shareholder 5	48	\$200,000
Shareholder 6	45	\$200,000

Maximum Defined-Benefit Plan

Consider first a defined-benefit plan designed to provide each shareholder with the maximum allowable benefit. Recall from above that, in 2004, the maximum benefit is \$165,000 annually beginning at age 62 through 65. Recall, also, that in order to achieve this benefit, the employee must participate in the plan for at least 10 years. Accordingly, shareholder 2 will be able to receive the full \$165,000 benefit only if he remains a participant in the plan until age 65. At age 65, shareholder 1 will have only 5 years of participation such that his benefit at such time cannot exceed \$82,500.

To achieve the full benefit over a 10-year period, shareholder 2 will need to accrue a benefit of \$16,500 each year. With compensation of \$200,000, this represents 8.25 percent of compensation. So the plan's benefit formula will be 8.25 percent of compensation per year of participation, to a maximum of 10 years.

For funding purposes, we will assume pre- and postretirement interest at 5 percent and the mortality table from Revenue Ruling 2001-62. Normal costs using ISG and unit credit funding are as follows:

	ISG	Unit Credit
Shareholder 1	\$182,934	\$166,322
Shareholder 2	160,730	130,317
Shareholder 3	114,134	112,573
Shareholder 4	93,688	102,107
Shareholder 5	78,236	92,614
Shareholder 6	61,140	80,004
Total	\$665,019	\$683,937

There is little difference in total funding when comparing the two funding approaches. However, on an individual basis, the funding difference is significant. For example, the funding cost for shareholder 2 is \$30,000 more using

ISG than that using unit credit funding. If costs are accounted for in determining total compensation, this cost differential is important.

Recall from our discussion of funding methods that unit credit funding most closely follows benefit obligations. We noted, in discussing payment of benefits, that in small plans, most employees take a lump sum and that the amount of the lump sum is the present value of the accrued benefit. What is the present value of the accrued benefit at the end of year 1? Well, if the funding assumptions match actuarial equivalence, it is equal to the normal cost under unit credit funding. Accordingly, if costs are accounted for in determining total compensation, unit credit funding makes a lot of sense.

Cash-Balance Plan

Not all groups want to fund at the levels shown above, and often the difference in cost is an issue notwithstanding the ability to even things up outside the plan. In such a case, a cash-balance plan would work well for PC.

A cash-balance plan could be designed providing for an annual contribution credit of \$80,000, such amount to be credited on the last day of the plan year. We chose \$80,000, because this is the closest amount to lowest maximum present value shown above. That is, since the plan above maximized benefits under a traditional defined-benefit plan, a contribution credit in excess of the \$80,000 could result in a benefit that could not be paid if shareholder 6 terminated early. We explain this in more detail in the following paragraphs.

Again, a cash-balance plan is a defined-benefit plan. As such, IRC Section 411(a)(7)(A) requires that the accrued benefit be provided in the form of an annuity beginning at normal retirement age. What is this annuity in a cash-balance plan? It is the monthly payment that would be paid if the hypothetical account balance is projected out to normal retirement age using the plan's interest crediting rate, and this amount were then used to purchase an annuity.

Let's look at the numbers for shareholder 6. For our purposes, we will assume that the applicable interest rate is 5 percent and that the plan's interest rate for actuarial equivalence is the applicable interest rate. Additionally, the plan uses the applicable mortality table (the table in Revenue Ruling 2001-62) for actuarial equivalence. The applicable interest rate is also used for providing the earnings credit, the interest credit added to the hypothetical account balance at the end of each year. In such a situation, the lump sum payable under the plan will equal the IRC Section 417(e) minimum and the IRC Section 415 maximum. In most cash-balance plans that the author designs, this is the case.

Account balance at the end of year one	\$ 80,000
Attained age at end of year one	46
Years to age 65 (normal retirement age)	19
Accumulation factor at 5%	2.527
Projected accumulated amount at age 65	202,160
Annuity purchase rate	12.252
Accrued benefit (\$202,160/12.252)	\$ 16,500

A contribution credit in excess of \$80,000 would result in an accrued benefit at the end of year one for shareholder 6 in excess of his maximum accrued benefit at that time. In other words, the maximum benefit that shareholder 6 could accrue is \$165,000, but that is only after 10 years of plan participation. After one year of plan participation, his maximum accrued benefit is one-tenth of this amount, or \$16,500.

Note that a contribution credit in excess of \$80,000 could be credited to shareholder 6; it just could not be paid right away. Note what happens in year two. In the following table, we assume that the applicable interest rate stays at 5 percent:

Account balance at beginning of year two	\$ 80,000
Earnings credit at 5%	4,000
Year two contribution credit	80,000
Account balance at the end of year two	164,000
Attained age at end of year one	47
Years to age 65 (normal retirement age)	18
Accumulation factor at 5%	2.4066
Projected accumulated amount at age 65	394,682
Annuity purchase rate	12.252
Accrued benefit (\$394,682/12.252)	\$ 32,214

At the end of year two, shareholder 6's accrued benefit is \$32,214. His maximum accrued benefit, however, would be \$33,000. A little math will show you that this is equivalent to a hypothetical account balance at the end of year two of about \$168,000. This would support a contribution credit of almost \$82,000 annually. So, a contribution credit in excess of \$80,000 would be permissible. Nevertheless, the early termination could result in a scenario in which it could not be paid out. Whether or not it could be funded depends on the funding method being used. If an excess contribution credit is being

funded, and early termination results in an accrued benefit that cannot be paid, it is not unusual to have something in the severance plan of a shareholder compensating him outside the plan for funded benefits that cannot be paid by the plan.

Combination Plans

It is possible that not all of the shareholders wish to fund at the levels above. Indeed, some of the shareholders may be happy at the maximum defined-contribution level of \$41,000 (the limit for 2004). In such a case, certain of the shareholders could be written out of the defined-benefit plan and a defined-contribution plan could be set up for these shareholders. The important thing to remember is that the minimum participation rules of IRC Section 401(a)(26) must be followed. In PC's case, this means that at least three of the six shareholders would need to be covered by the defined-benefit plan.

Note that if any of PC's shareholders wished to be in both plans, a deduction limit could cause a problem. IRC Section 404(a)(7) imposes a deduction limit under which a company sponsors both a defined-benefit plan and a defined-contribution plan and at least one employee is a participant in both plans.

If IRC Section 404(a)(7) applies, the maximum deductible amount is the greater of 25 percent of compensation or the amount required to be deposited into the defined-benefit plan to meet its minimum funding requirements for the year. In measuring the deductible limit, compensation is limited to the maximum compensation includible under IRC Section 401(a)(17), which is \$205,000 for 2004.

In PC's case, any crossover participation would result in a deductible limit of \$300,000. In determining this amount, however, elective deferrals to 401(k) plans are not included. (See IRCode Section 404(n).)

Let's take a look, then, at what could be accomplished if shareholders 1 to 3 each wish to shelter \$85,000, but shareholders 4 to 6 each wish to shelter only \$41,000. The design could take on the following characteristics:

- Each shareholder defers \$13,000. (We will ignore catch-ups.)
- Each shareholder receives an allocation of \$28,000 under a profit-sharing plan.
- A cash-balance plan is established covering shareholders 1, 2, and 3 only. Shareholders 4, 5, and 6 are excluded from plan participation.
- A contribution credit of \$44,000 is provided for each participant in the cash-balance plan.
- Cash-balance funding equals contribution credits.

The numbers would work out as follows:

	Profit Sharing	401(k)	Cash Balance	Total
Shareholder 1	\$ 28,000	\$13,000	\$ 44,000	\$ 85,000
Shareholder 2	28,000	13,000	44,000	85,000
Shareholder 3	28,000	13,000	44,000	85,000
Shareholder 4	28,000	13,000	—	41,000
Shareholder 5	28,000	13,000	—	41,000
Shareholder 6	28,000	13,000	—	41,000
Total	\$168,000	\$78,000	\$132,000	\$378,000

Remember that the 401(k) deferrals are not counted in determining the deductible limit. So, only the cash-balance contribution and the profit-sharing contribution must be considered. These amounts total \$300,000, the deductible limit as indicated above.

Chapter 11

Fully Insured Defined-Benefit Plans— Internal Revenue Code Section 412(i)

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Fully Insured Defined-Benefit Plans— Internal Revenue Code Section 412(i)

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This chapter provides a basic discussion of a type of defined-benefit plan known as a fully insured defined-benefit plan. We will focus on the traditional concept of this type of plan, though, in recent years, a number of particularly aggressive fully insured designs have been heavily sold by some high-powered marketing organizations and have come under scrutiny by the Internal Revenue Code (IRC).

Definition

A 412(i) plan is a defined-benefit retirement plan, the funding requirement of which falls under IRC Section 412(i). If a plan meets the requirement of this subsection, it is exempt from the complex funding rules of IRC Section 412 applicable to all other defined-benefit plans.

A 412(i) plan is *only* different in the area of funding. It must meet all requirements of IRC Section 401 regarding qualified plans.

Requirements

A 412(i) plan must be funded exclusively with annuity contracts or a combination of insurance and annuity contracts. The contracts must provide for level annual premium payments to begin when the individual becomes a plan participant and extending not later than the retirement date under the plan. Dividends, when payable, must be used to reduce the premium of the contracts.

The plan benefit must be provided entirely by these contracts and guaranteed by an insurance carrier to the extent premiums have been paid. There is an exception that allows for a separate accumulation fund for providing top-

heavy minimum benefits. This usually applies only in the early years of a participant's participation in the plan and only until the cash value of the contracts grows to an adequate enough amount to provide at least the minimum top-heavy benefits on their own.

Premiums (for current and all prior plan years) must have been paid. No rights under the contracts may be subject to a security interest during the plan year and no policy loan may be outstanding at any time during the plan year.

Advantages of 412(i) Plans

Unlike the more common type of defined-benefit plan, there is no full funding limitation or current liability test applied to limit the deduction to a 412(i) plan.

In a traditional fully insured plan, the assets (which are the values of the contracts) are exactly equal to the monthly benefits payable to participants. This means that, by definition, there can be no overfunding of the monthly benefit. No overfunding means that there would be no reversion penalty tax because there would not be any leftovers reverting to the employer in the event of plan termination.

However, there can be an overfunding if lump-sum payments are intended and the guaranteed amounts under the contract exceed the IRC Section 415 maximum for the lump-sum values that are payable to the participant.

Similarly, there can be no underfunding in a 412(i) plan since the payment of the required premium will always keep the accrued benefits equal to the amount of benefits provided by the contracts. If a 412(i) plan terminates, the plan sponsor will not have to come up with additional funds in order to fully pay out the participants the amounts to which they are entitled, since the amounts they are entitled to are simply the amounts in the contracts.

Unlike the non 412(i) defined-benefit plan, generally no enrolled actuary needs to be involved in a 412(i) plan. The actuaries who determined the pricing and values of the contracts have provided a prepackaged program: Simply pay the premium and you will always have the right amount of benefits. No actuary's statement (the Schedule B attachment to the 5500 annual return for the plan) is required for a fully insured defined-benefit plan (unless there is a top-heavy accumulation fund as noted above).

A regular defined-benefit plan requires that quarterly contributions are to be made. That is not the case in a 412(i) plan, but premiums *must* be paid as they are due (there is no flexibility regarding the timing of the payments, which might be considered a more rigorous requirement than required quarterly contributions).

Significantly larger contributions (deductions) are available than would be the case in a traditional defined-benefit plan.

Plan funding assumptions should not be subject to attack by the Internal Revenue Service (IRS), since the assumptions are mandated to be the guarantees in the insurance company contracts. Nonetheless, the IRS is well aware of the aggressive product marketing and is attempting to shut them down, as they have done with voluntary employees' beneficiary associations (VEBA) plans.¹

Benefits are guaranteed by the insurance company. This means the insurance company bears the investment risk. The contract values are not influenced by market fluctuations and, therefore, the contracts provided a relatively conservative rate of return.

Employer funding of the plan is simpler to understand than a traditional defined-benefit plan, since the plan sponsor simply pays the premiums as they become due.

The nature of the insurance contract funding generally leads to high contributions in the early years of the plan's operation. As dividends on the contracts tend to increase over time, future premiums will be reduced by the increasing dividends payable on the insurance contracts.

By the operation of the insurance contracts, it is possible to totally fund benefits early. At some point, the dividend could be equal to the premium, thus requiring no additional contributions from the plan sponsor. Additionally, in a maximum benefit situation in which lump-sum distributions are contemplated, it may be appropriate to stop premium payments early so as not to have the contract values exceed what can actually be paid out to the participants under the IRC Section 415 limits.

The use of insurance contracts and the lack of required actuarial services could possibly result in lower administrative fees to operate the IRC Section 412(i) plan.

Disadvantages of 412(i) Plans

- There is no flexibility in investments. The assets must be held by an insurance company in insurance contracts.

¹ A VEBA (also known as an IRC Section 419A plan) is a tax-exempt organization, as described in IRC section 501 (C) (9), that has received a tax exemption letter from the IRS. The VEBA usually provides for the payment of life, accident, sickness, and other benefits to the participants in the VEBA, their dependents or beneficiaries. In most cases, a VEBA is set up as a trust with a bank as the trustee. The earnings of a VEBA trust are tax-exempt.

Since 1928 Congress has permitted businesses to use VEBAs to provide welfare benefits. Welfare benefits are payable upon the occurrence of an event that is not necessarily within the control of the benefit recipient (e.g., life insurance payable upon the death of a covered employee).

VEBAs are subject to some provisions of ERISA; however they are not subject to the rules governing qualified plans. The IRS has proposed certain guidelines with which VEBAs must comply. A properly designed VEBA receives a letter of determination from the IRS granting it tax-exempt trust status.

For more on IRS treatment of VEBAs, see www.irs.gov/irm/part4/ch51s16.html.

- Premiums must be paid as they come due. There is no flexibility in the timing of contributions, and no policy loans are allowed.
- The premiums are determined by insurance company product rates. There is no flexibility in payments or costs.
- No participant loans are allowed in a 412(i) plan, though some administrators might suggest that the lack of participant loans and the reduced administrative complexity that the elimination of those loans brings to the administration of a plan might be considered an advantage.

Who is the ideal prospect?

The ideal prospect for a 412(i) plan is a small business. Generally, we would expect to find a highly paid owner, age 40 to 75. In the best situation, there are few other employees (or none). If there are other employees, it is best if they are younger than the owner and relatively low paid. An alternative good prospect situation is that all other employees are family members.

The ideal candidate would have a strong stability of business income (profits) and a desire to maximize deductions to the retirement plan. Investment flexibility must not be an important objective.

Designing Fully Insured Plans Under GATT Limitations

The funding contracts have minimum guarantees that are used to determine the premiums to be paid.

Typically, the funding contracts provide for sharing the actual, higher rate of return earned on the contract premiums with the contract owner through dividends or excess interest credit paid to the policy holder. As noted earlier, these dividends must be used to reduce the premium.

The nature of dividends is that they will increase over time, thus lowering the cost of the 412(i) plan year by year. That is why the 412(i) plan contributions will be greater in the early years and will decrease over time if the benefit otherwise stays the same.

A traditional defined-benefit plan, as a result of full funding limitations built into the law, tends to have a pattern of increasing costs over time. Reduced (limited) early year costs are pushed off to future years during which they must ultimately be funded.

A 412(i) plan is subject to the same maximum benefit limitations and top-heavy provisions as a traditional defined-benefit plan.

The 1994 General Agreement on Tariffs and Trade (GATT) included the Retirement Protection Act (RPA 94) which limits the maximum defined-benefit payout. The maximum lump-sum equivalent of the maximum monthly benefit is based on a specified mortality table (the 50/50 blended male/female

table) and an interest rate based on the 30-year Treasury securities, which, by the way, are no longer in existence!² This interest rate changes monthly.

If the participant takes the benefit as an annuity payout, there is no problem with the above. However, if the participant takes a lump sum (and when was the last time you saw an annuity payout in a small business defined-benefit plan), the lump-sum value under the guaranteed contract conversion factor could be 40 percent higher than the maximum amount determined under the GATT rates.

If the participant takes the maximum lump sum, it could leave excess assets in the plan after the participant retires. If not reallocated to remaining participants, this would revert to the employer and be subject to the applicable 50-percent excise tax (plus ordinary income taxation). Under current law, the maximum retirement benefit is limited to annual payments of \$160,000 per year.

Generally, there are two approaches to addressing this excess asset problem inherent in the 412(i) design, namely, the safe approach and the aggressive approach. These are discussed in the following sections. In addition, there is also a middle ground approach, which is also discussed, in a separate section.

Safe Approach

Determine an assumed GATT interest rate at retirement age to determine the maximum lump-sum payout available.

Use the insurance company guaranteed rate to determine the equivalent guaranteed annuity amount of the GATT maximum. This will be a monthly benefit *lower* than the maximum statutory monthly benefit that could be provided if an annuity was actually taken instead of a lump sum.

Use this lower monthly benefit as the maximum in determining the formula for the 412(i) plan. At retirement, the lowered monthly benefit would produce the maximum GATT payout.

This design will generally still provide larger current deductions than a traditional defined-benefit plan because the interest rate assumed in the contract is usually around 3 to 4 percent versus the possible 6- to 8-percent rate that might be used by the actuary in funding the traditional plan.

Aggressive Approach

Under an aggressive approach, the excess asset problem inherent in the 412(i) design is addressed as follows:

1. Fund for the maximum annuity (knowing that excess assets will accumulate that cannot be paid as a lump sum).

² The 30-year Treasury constant maturity series was discontinued as of 2/18/02. For Public Debt information contact US Treasury Office of Debt Management at (202) 219-3350 or visit www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/.

2. Fund the plan for a limited number of years at the maximum.
3. Freeze the plan when the current contract values, projected at the actual *expected* rate of return, would grow to be equal to the GATT 415 maximum at retirement. The contracts would either be put on a paid-up option or surrendered, depending on the desires and needs of the client.
4. The plan ceases to be a 412(i) plan at this point and is now subject to actuarial certification.
5. At a later date, the plan can be unfrozen by amendment and the formula increased to use up the excess.

It should also be noted that the GATT 415 maximum dollar limit and corresponding lump-sum payout limit would be subject to cost-of-living adjustments (COLAs) increases which could help eat up the excess assets (and provide an even larger payout than the original calculations).

Middle-Ground Approach

The middle-ground approach is accomplished by the following steps:

1. Fund the plan for a limited number of years at the maximum deductible level.
2. Terminate the plan prior to retirement while the assets do not yet exceed the GATT limit. This requires monitoring the plan and the GATT rates each year to determine when the benefits are nearing the limits and terminating the plan in the year prior to the time when the GATT limit would be exceeded.
3. Roll over the defined-benefit assets into an IRA or other defined-contribution plan.

This process generally would require the services of a professional pension consulting/administration firm to monitor the plan and make the necessary calculations to prevent the plan assets from exceeding the GATT limits.

Top-Heavy Rules

A 412(i) plan must satisfy the top-heavy provisions of IRC Section 416.

A plan is considered top heavy if more than 60 percent of its accrued benefits inure to the benefit of key employees. Generally, this means owners of 5 percent or more of a business and other highly compensated employees (HCEs).

It should be expected that every 412(i) plan will be top heavy and have to meet the IRC Section 416 rules. The top-heavy rules require that a plan must normally provide a minimum monthly retirement benefit of 2 percent of com-

pensation per year of service for each top-heavy year up to a maximum of 10 years to a maximum of a 20-percent monthly benefit.

A problem is that this top-heavy minimum accrues rapidly and the level premium contracts may not have sufficient cash to guarantee the accrued benefit in the early years of the plan.

There are two possible solutions to the top-heavy issue. The first is to solve the problem through plan design, by having a benefit formula that is much higher than the minimum top-heavy requirements so that the minimum top-heavy minimum accruals are met by the actual cash accumulations in the early years of the higher formula.

It is permissible to provide additional funding outside the whole life insurance and annuity contracts without jeopardizing the plan's fully insured status. A small separate account can be established to fund the minimum accruals in case the employee (or the plan) terminates in the early years of participation. Note that plans utilizing this method of meeting top-heavy minimums will be required to have actuarial certification and Schedule B filings with regard to this accumulation fund.

Conversion of Existing Defined-Benefit Plans

An existing defined-benefit plan can be converted into a 412(i) plan. Revenue Ruling 81-196 outlines the procedures for converting existing defined-benefit plans that are not fully insured to fully insured plans.

Existing accrued benefits at the time of the conversion must be funded with single premium retirement annuities (SPRS) that have a cash value equal to the present value of the accrued benefits for the plan as of the conversion date.

The guaranteed projected benefit at retirement provided by the SPRA is used to offset the total benefits provided under the fully insured plan at retirement, with the balance provided just as it would be under a new fully insured plan.

In order to become a 412(i) plan, all existing assets of the old defined-benefit plan must be transferred to the insurance company so that the benefits become guaranteed by the insurance company.

Conversion as Insurance Company Solution to Overfunded Defined-Benefit Plan

Reputable insurance companies often offer a fully insured conversion as a solution to absorb excess assets from an existing defined-benefit plan. This supposedly reduces the possibility of the 50-percent excise tax for reversion.

However, this will only work if the participants are either not near their GATT 415 limit, or want to take an annuity payout.

As an alternative, if they are not near their GATT 415 limit, then the plan could be amended to simply increase the benefit levels to absorb the excess assets.

And, if they want to take an annuity payout, annuities could be bought by the traditional defined-benefit plan and that would accomplish the same absorption of excess assets.

Abusive Designs

There are a number of marketing organizations aggressively marketing very attractive illustrations of fully insured plans; perhaps too attractive. What are the problems?

Most of them are predicated on some limited payment of premiums and then terminating the plan and rolling out the insurance while it has low cash values (via high surrender charges).

The companies claim they are not springing cash value contracts, but they sure smell like them. One illustration I reviewed shows three annual premiums of \$100,000 and a cash surrender value at the end of three years of \$25,420. It is not unusual for such a policy to provide a commission equal to 100 percent of the first year's premium with significant renewal commissions as well.

The IRS and the Department of the Treasury are fully aware of these deals and are actively analyzing them. They have indicated that they will shut them down if they are found to be abusive. Given their recent record of pursuing and shutting down abusive IRC Section 419A (VEBA) plans, the IRS and the Department of the Treasury are confident of the success of their project.

Bottom line: 'If it sounds too good to be true, it probably is.'

Comparison With Other Plans

The following table compares the fully insured defined-benefit plan to other plans.

First-Year Contributions

		Contributions			Percent Higher for Fully Insured Plans	
	Attained Age/ Retirement Age	Defined Traditional Contribution	Defined Benefit*	Fully Insured*	Defined Contribution	Traditional Defined Benefit
Ethan	45/62	35,000	75,160	145,236	315%	93%
Steve	50/62	35,000	128,166	236,305	575%	84%
Jeff	55/62	35,000	188,209	332,357	850%	77%
Jim	60/65	35,000	194,847	338,216	866%	74%

* In IR-2004-21 (Feb. 13, 2004) IRS Warns of Abusive 412i Plans.

The Treasury Department and the IRS issued guidance to shut down abusive transactions involving specially designed life insurance policies in retirement plans, IRC Section 412(i) plans. The guidance designates certain arrangements as “listed transactions” for tax-shelter reporting purposes. For additional information, see:

- Revenue Ruling 2004-20, Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans, <http://www.irs.gov/pub/irs-utl/rr-04-20.pdf>.
- Revenue Ruling 2004-21, <http://www.irs.gov/pub/irs-utl/rr-04-21.pdf>.
- Proposed Regulation 126967-03, <http://www.irs.gov/pub/irs-utl/402reg.pdf>.
- Revenue Procedure 2004-16, <http://www.irs.gov/pub/irs-utl/rp-04-16.pdf>.
- News Release IR-2004-21, <http://www.irs.gov/pub/irs-utl/ir-04-021.pdf>.

Chapter 12

Plan Correction Programs— EPCRS, VFCP, and DFVC

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Plan Correction Programs— EPCRS, VFCP, and DFVC

The Internal Revenue Service's (IRS's) Employee Plans Compliance Resolution System (EPCRS) and the Department of Labor's (DOL's) Voluntary Fiduciary Correction Program (VFCP) are discussed in this chapter. The EPCRS is a comprehensive system of integrated correction programs that plan sponsors may use to correct eligible failures and to continue providing their employees with retirement benefits on a tax-favored basis. The VFCP allows certain persons to avoid potential civil actions, penalties, and the assessment of civil penalties under Employee Retirement Income Security Act of 1974 (ERISA). In general, the exemption affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.

Achieving a good result under the EPCRS and VFCP requires plan sponsors and their advisers thoroughly understand all of the correction principles available and how those principles can be best applied under various facts and circumstances. Care must also be taken in determining whether a plan defect or multiple plan defects would be treated as significant or insignificant by the IRS under the EPCRS. Competing and sometimes conflicting correction principles may provide one solution that is better than another solution.¹

The Delinquent Filer Voluntary Compliance Program (DFVC), designed to encourage voluntary compliance with the annual reporting requirements under ERISA is also discussed in this chapter.

¹ C. Frederick Reish, Bruce Ashton, and Nicholas J. White, *Journal of Taxation* (September 2003).

Employee Plans Compliance Resolution System

Compliance Qualification Failures

A *compliance qualification failure* is a any failure that adversely affects the tax-sanctioned status of a qualified plan,² simplified employee pension plan (SEP), or a savings incentive match plan for employees (SIMPLE) individual retirement account or annuity (IRA) plan of an employer. The four types of compliance qualification failures under EPCRS are:

1. *Plan Document Failure.* A provision (or the absence of a provision) within the plan's written document that, on its face, violates Internal Revenue Code (IRC or the Code) provisions³
2. *Operational Failure.* A problem (other than an employer eligibility failure) that arises solely from a failure to follow plan provisions (Failure to follow the terms of a plan providing for the satisfaction of non-discrimination requirements of IRC Sections 401(k) and 401(m) is generally treated as an operational failure except to the extent the plan can be amended retroactively or, if amended, the provisions of the amendment were not followed).⁴
3. *Demographic Failure.* A violation of the nondiscrimination and/or the participation and coverage requirements that is not an operational or employer eligibility failure (Generally, a corrective amendment adding more benefits or increasing existing benefits is required to correct a demographic failure.)⁵
4. *Employer Eligibility Failure.* The adoption of a plan by any ineligible employer, e.g., salary-reduction or elective simplified employee pension plan (SARSEP) adopted by a tax-exempt organization or a savings incentive match plan for employees, SIMPLE IRA plan adopted by an employer that is making contributions to a profit-sharing plan for its nonunion employees (An employer eligibility failure is not a plan document, operational, or demographic failure.)⁶

Generally, none of the correction programs are available to correct failures that can be corrected under the Code and related regulations nor, in general, relieve any excise and additional taxes that may be due.⁷

² A *qualified plan* is a plan that satisfies the requirements of IRC 401(a). Qualified plans include defined-benefit plans, profit-sharing plans, money-purchase pension plans, IRC 401 (k) plans, and stock bonus plans, including employee stock ownership plans (ESOPs). Under EPCRS, a defect in a qualified plan is referred to as a *qualification failure*, which is any operational or form problem that adversely affects the qualification of a plan. See Rev. Proc. 2003-44, Section 5.01(2), 2003-25 IRB 1051.

³ Rev. Proc. 2003-44, Sections 5.01(2)(a), 5.04, 5.05, 2003-23 IRB 1051; See, general requirements at IRC Sections 401(a) for qualified plans, e.g., 403(a), for qualified annuity plans, 408(k) for SEPs, and 408(p) for SIMPLE-IRA plans.

⁴ IRC Section 401(b); Rec. Proc. 2003-44, Sections 5.01(2)(b), 5.04, 5.05, 2003-23 IRB 1051.

⁵ Rev. Proc. 2003-44, Sections 5.01(2)(c), 5.04, 5.05, 2003-23 IRB 1051; See, requirements at IRC Sections 401(a)(4), 401(a)(26), 408(k), 408(p) or 410(b).

⁶ Rev. Proc. 2003-44, Section 5.01(2)(d), 2003-23 IRB 1051.

⁷ Rev Proc 2003-44, Sections 6.08, 6.09, 2003-23 IRB 1051.

With respect to SEP and SARSEP, the following qualification failures are mentioned:⁸

- Failure to satisfy the 125-percent deferral percentage test in a SARSEP
- Undercontributions to a SEP
- Failure to satisfy the 50-percent participation rate requirement for a SARSEP
- Failure to satisfy the 25-employee limitation for a SARSEP

Operational SEP and SIMPLE IRA failures corrected under The Self-Correction Program (SCP) are only available for insignificant failures. Employer eligibility failures may also be corrected under the Voluntary Correction With Service Approval Program (VCP).

Correction Programs

Under EPCRS, the IRS provides three programs that are available for solving a compliance qualification failure.⁹ The programs are referred to as:

1. The Self-Correction Program (SCP)
2. The Voluntary Correction With Service Approval Program (VCP)
3. The Correction on Audit Program (Audit CAP)

Employers may not use the SCP for eligibility failures; SCP is not available to correct egregious failures. Egregious failures (and employer eligibility failures) can be corrected under VCP.¹⁰

The SCP is available if the plan is being audited by the IRS; but, in general, it can be used only to correct insignificant operational failures once the plan is being audited by the IRS.¹¹

Example. Scrooge Company has consistently covered only highly compensated employees (HCEs) under its plan. Alpha company has made contributions for the HCEs over the IRC Section 415 limit. Both Scrooge and Alpha have committed an egregious failure that can be corrected under VCP.

SCP, VCP, and Audit CAP are not available for qualification failures relating to the diversion or misuse of plan assets.¹² Moreover, since significant failures for SEP and SIMPLE IRA plans cannot be corrected under the SCP, an employer must use the VCP or Audit CAP to correct a significant failure.¹³

⁸ Rev. Proc. 2003-44, Section 6.10(3)-(5), 2003-23 IRB 1051.

⁹ Rev. Proc. 2003-44, Sections 2003-44, 1.03, 2003-23 IRB 1051.

¹⁰ Rev. Proc. 2003-44, Section 4.08, 2003-23 IRB 1051.

¹¹ Rev. Proc. 2003-44, Section 4.02, 2003-23 IRB 1051.

¹² Rev. Proc. 2003-44, Section 4.09, 2003-23 IRB 1051.

¹³ Rev. Proc. 2003-44, Section 7, 2003-23 IRB 1051.

Correction Principles

Generally, under EPCRS, a qualification failure is not considered corrected unless full correction is made with respect to all participants and beneficiaries and for all taxable years, including taxable years that are closed.¹⁴

In determining whether full correction is accomplished, a plan must use a correction method that is reasonable and appropriate and that restores the plan to the position that it would have been in had the qualification failure not occurred. Restoring the plan to this position also means the restoration of current and former participants and beneficiaries to the benefits and rights they would have had if the qualification failure had not occurred.¹⁵ Whether a particular correction method is reasonable and appropriate should be determined taking into account relevant facts and circumstances and the following principles:¹⁶

- The correction method should, to the extent possible, resemble one already provided for in the IRC, regulations thereunder, or other guidance of general applicability.
- The correction method for a qualification failure relating to nondiscrimination should provide benefits to nonhighly compensated employees (NHCEs).
- The correction method should keep assets in the plan except to the extent the law permits corrective distributions to participants or beneficiaries or the return of assets to the employer.
- The correction method should not violate any other qualification requirement.

If more than one correction method is available to correct a particular type of operational failure, the correction method should be applied consistently in correcting all operational failures of that type for that plan year. For group submissions, the consistency requirement applies on a plan-by-plan basis.¹⁷

Exceptions to Full Correction

Full correction is not required, however, in certain situations because it is unreasonable and not feasible. For example, reasonable estimates of benefits are allowed if it is not possible to make a precise calculation or if the probable difference between the approximate and precise amount of benefits is insignificant and the administrative cost of determining the precise amount of benefits would significantly exceed that difference. The method must not discriminate significantly in favor of HCEs. Corrective distributions are not required if the participant or beneficiary cannot be located. Corrective distribution of benefits of \$50 or less is not required if the cost of processing and delivering the distri-

¹⁴ Rev. Proc. 2003-44, Section 6.02, 2003-23 IRB 1051.

¹⁵ Rev. Proc. 2003-44, Section 6.02(1), 2003-23 IRB 1051.

¹⁶ Rev. Proc. 2003-44, Section 6.02(2), 2003-23 IRB 1051.

¹⁷ Rev. Proc. 2003-44, Section 6.02(3), 2003-23 IRB 1051.

bution exceeds the amount of the distribution.¹⁸ In addition, the employer is not required to seek the return of an overpayment to a participant or beneficiary if the over-payment is \$100 or less, and the employer notifies the participant or beneficiary that the overpayment is not eligible for rollover.¹⁹

Corrective Allocation Principles

The following principles apply in determining corrective allocations and distributions:²⁰

- Corrective allocations should be based on the terms of the plan in effect at the time of failure and should be adjusted for earnings (or losses and forfeitures) that would have been allocated but for the failure. Adjustments for losses are not required.
- A corrective allocation of contributions, forfeitures, or both is considered an annual addition under IRC Section 415 for the limitation year to which the corrective allocation relates. However, the normal rules under IRC Section 404(j) prohibiting allowable deduction from exceeding IRC Section 415 limits apply.²¹
- Corrective allocations should come from employer contributions but may come from forfeitures if the plan permits the use of forfeitures to reduce employer contributions.

The Self-Correction Program

Except for insignificant defects that are detected during an IRS audit, the SCP is designed to be initiated by the plan sponsor or the plan administrator, without IRS involvement, with respect to any plan eligible for SCP.²² No sanctions or penalties are payable to the IRS in connection with use of SCP. The only cost to the plan sponsor is the cost of correcting the defect. A correction of a failure identified on audit requires IRS approval and the payment of a negotiated sanction. Self-correction only applies to insignificant operational failures in a SEP or SIMPLE IRA plan of an employer even if they are discovered by an agent upon examination.²³

SCP is designed to cover qualification defects that arise from the failure to operate a plan in accordance with its terms. SCP is not available to cure qualification issues arising from defects in the plan document, e.g., a failure to amend for the Tax Reform Act of 1986 (TRA 86). It is also not available for qualification issues that arise because of a shift in demographics, e.g., a problem with the minimum coverage rules under IRC Section 410(b). Finally, SCP

¹⁸ Rev. Proc. 2003-44, Section 6.02(5)(b), 2003-23 IRB 1051.

¹⁹ Rev. Proc. 2003-44, Section 6.02(5)(c), 2003-23 IRB 1051.

²⁰ Rev. Proc. 2003-44, Section 6.02(4), 2003-23 IRB 1051.

²¹ IRC Section 404(j)(1).

²² Rev. Proc. 2003-44, Section 7, 2003-23 IRB 1051.

²³ Rev. Proc. 2003-44, Section 8.01.

cannot be used to correct operational failures that are egregious or that relate to the diversion of assets.²⁴

Under the SCP, operational defects must generally be corrected by the end of the second plan year following the plan year in which the defect arose. Significant operational defects relating to assets transferred to a plan in connection with a merger or acquisition can be corrected up to the last day of the plan year following the plan year in which the merger or acquisition occurs. Failures treated as insignificant can be corrected after these deadlines.²⁵

Example. Titanium Company sponsors a 401(k) plan with a plan year ending December 31. Titanium did not make a required top-heavy minimum contribution for the 2003 plan year. In addition, the plan failed to satisfy the ADP test. These failures are discovered in March 2005. Assuming Titanium otherwise satisfies the eligibility requirements for SCP, it has until the end of 2005 to correct the missing top-heavy minimum contribution. Correction of the failed ADP test could wait until December 31, 2006, as the two-year correction period is considered to begin one year after the plan year of failure.²⁶

Significant or Insignificant

The factors to be considered in determining whether or not an operational failure is insignificant include but are not limited to the following:

1. Whether other failures occurred during the period being examined
2. The percentage of plan assets and contributions involved in the failure
3. The number of years the failure occurred
4. The number of participants affected versus the total number of participants
5. The number of participants affected versus the total number of participants that could have been affected
6. Whether correction was made within a reasonable time after the failure's discovery
7. The reason for the failure

No single factor is determinative and the factors listed in the above as items 2, 4, and 5 should not be interpreted to exclude small business owners.²⁷

Favorable Letter Requirement

In order to correct significant operational failures (but not insignificant failures), the plan must have a favorable IRS letter. A favorable IRS letter is, in the case of an individually designed plan, a current favorable determination

²⁴ Rev. Proc. 2003-44, Section 4.01(1), 2003-23 IRB 1051.

²⁵ Rev. Proc. 2003-44, Sections 8.01 and 9.02, 2003-23 IRB 1051.

²⁶ Rev. Proc. 2003-44, Section 9.02, 2003-23 IRB 1051.

²⁷ Rev. Proc. 2003-44, Section 8.02, 2003-23 IRB 1051]

letter. Adopters of master or prototype plans and volume submitter plans will be considered to have favorable letters if the sponsors of these plans have received current favorable opinion or advisory letters. In the case of a SEP or SIMPLE IRA plan, the plan document must be a valid IRS approved model or prototype plan regardless of whether the operational failure is significant or insignificant.²⁸

Established Practices and Procedures

Before SCP can be used to correct an operational failure, the plan must have had established practices and procedures (whether formal or informal) that were reasonably designed to promote and facilitate overall compliance. Operational violations must have occurred because of an oversight or mistake in applying them or because of their inadequacy.²⁹

Anonymous Submission Procedure

The IRS has established a procedure called the Anonymous Submission Procedure that permits any failure to be addressed without identifying the plan or its sponsor.³⁰ A plan is not eligible to submit under the anonymous submission procedure if the plan or the plan sponsor is under examination. A fee associated with a request submitted under the anonymous submission procedure is broken into two payments, namely, a nonrefundable payment at the beginning of the process (with the initial request), and a second payment at the end of the process, if applicable. The fee is based on various guidelines.

A submission under the anonymous submission procedure does not preclude or impede an examination of the plan sponsor or the plan before the date on which identifying information is provided to the IRS.

Safe Harbors

Correction methods described in Appendixes A and B of Revenue Procedure 2003-44 are generally viewed as safe-harbor methods that may be used to resolve eligible operational failures through VCP.

Group Submission Procedures

A group submission procedure enables an eligible organization to address systemic operational and plan document errors that affect at least 20 client plans. An eligible organization includes a sponsor of a prototype plan or an organization that provides administrative services with respect to qualified plans.³¹

²⁸ Rev. Proc. 2003-44, Section 4.03, 2003-23 IRB 1051.

²⁹ Rev. Proc. 2003-44, Section 4.04, 2003-23 IRB 1051.

³⁰ See, Rev. Proc. 2003-44, Section 10.11, 2003-23 IRB 1051.

³¹ See, Rev. Proc. 2003-44, Section 10.12, 2003-23 IRB 1051.

Voluntary Correction With Service Approval Program

The VCP is designed to cover all types of qualification defects, namely, operational, plan document, and demographic. VCP is not available, however, to cure any violations of the exclusive benefit rule (e.g., misuse or diversion of plan assets).³² Although there is no deadline, VCP is not available if the plan is being audited by the IRS.³³ Unlike SCP, established practices and procedures are not required to be in effect in order to utilize VCP.³⁴

Under VCP, a plan sponsor may correct an operational failure by a plan amendment to conform the terms of the plan to the plan's prior operations. Any retroactive amendment is required to be submitted to the IRS for its approval unless the amendment is accomplished through the adoption of an IRS model amendment or the adoption of an IRS-approved prototype or volume submitter plan.³⁵ A favorable IRS letter is not required to take advantage of VCP.³⁶

Procedures

The plan sponsor initiates the program by preparing an application to the IRS that contains all the relevant information.³⁷ Essentially, the plan sponsor must describe the defect and the correction and explain why the problem will not recur.

The IRS will respond to a VCP application with a compliance statement that addresses the failure and the terms of its correction and that contains the IRS's agreement not to disqualify the plan³⁸ on account of the operational failure described in the compliance statement. Within 30 days after the statement is issued, a plan sponsor that agrees with the statement must send a signed acknowledgment letter to the IRS. If this acknowledgment is made, the plan sponsor has 150 days after the issuance of the compliance statement to correct the operational failure.

Except for failure to satisfy the IRC Section 401(a)(9) minimum distribution rules, the VCP will not provide the plan sponsor with relief from any excise taxes. Nor is there any relief from the fiduciary conduct provisions under ERISA's Title I, if applicable. (See the section entitled "DOL Voluntary Fidu-

³² Rev. Proc. 2003-44, Section 1.03, 2003-23 IRB 1051.

³³ Rev. Proc. 2003-44, Section 4.02, 2003-23 IRB 1051.

³⁴ Rev. Proc. 2003-44, Section 4.04, 2003-23 IRB 1051.

³⁵ Rev. Proc. 2003-44, Sections 4.05(1), 4.06, 2003-23 IRB 1051.

³⁶ Rev. Proc. 2003-44, Section 4.03, 2003-23 IRB 1051.

³⁷ Rev. Proc. 2003-44, Section 11, 2003-23 IRB 1051.

³⁸ Plan disqualification results in (a) under IRC Section 404(e)(5), the plan sponsor loses its deduction for contributions to the plan during the open tax years under the statute of limitations to the extent the contribution is not vested for the plan participants; (b) for a defined-benefit plan, plan disqualification results in a total loss of the deduction (other than for a one-person plan), see Treas. Reg. 1.404(a)-12(b); (c) for tax years still open under the statute of limitations, the employee recognizes as income the vested portion of his or her plan benefit, see IRC Sections 402(b), 6501; (d) for tax years still open under the applicable statute of limitations, the plan's related trust recognizes any earnings as income for income tax purposes, see IRC Section 501 (a); and (e) distributions become ineligible for special tax treatment and cannot be rolled over on a tax-deferred basis (e.g., any amounts rolled over to an IRA or another qualified plan would not be excluded from income by reason of the rollover), see IRC Section 402(d).

ciary Correction Program,” in this chapter.) These factors must be considered in reviewing the decision to use VCP and in analyzing the costs involved.

Correction on Audit Program

Audit CAP is available to a plan sponsor if the qualification defect (other than an insignificant operational error that can be handled through SCP) is discovered by the IRS during an audit. All defects that may be corrected under VCP may also be corrected under Audit CAP. If the plan sponsor corrects the qualification failures identified by the IRS, pays a sanction, and enters into a closing agreement with the IRS, then the IRS will not disqualify the plan on account of the qualification defect.³⁹

The amount of the sanction is a negotiated percentage of the full amount of the tax liability that would be due the IRS if the plan were disqualified for the years open under the statute of limitations (known as the *maximum payment amount*). The maximum payment amount will include taxes based on the loss of the employer’s deduction for plan contributions, taxes on trust earnings, taxes on individual employees for inclusion of plan contributions in their taxable compensation, and any penalties and interest that would accrue on any of these amounts. The negotiated percentage is to bear a reasonable relationship to the nature, extent, and severity of the failures and must not be excessive.⁴⁰

EPCRS for SEP and SIMPLE IRA

Generally, the correction used for a SEP or SIMPLE IRA may either be similar to the correction method required for a qualified plan or 403(b) with a similar qualification failure, or a specific correction method listed for SEP or SIMPLE Plans.⁴¹

Under the VCP, if a correction method that applies to a qualified plan is not feasible for a SEP or the IRS determines such method is not feasible, the IRS may provide a different correction method. Many of the correction methods do not address the employer’s lack of control over the accounts established by employees which are used to receive the SEP or SIMPLE IRA contributions.

The Revenue Procedure lists the following failures as being included in failures that may need a different correction:

1. Failures relating to 402(g), 415, or 401(a)(17)
2. Failures relating to deferral percentages
3. Discontinuance of contributions to a SARSEP
4. Retention of overcontributions for situations in which there was no violation of a statutory provision

³⁹ Rev. Proc. 2003-44, Section 13, 2003-23 IRB 1051.

⁴⁰ See Rev Proc 2003-44, Section 14.02 (2003-23 IRB 1051) examples of factors taken into account in arriving at the negotiated percentage.

⁴¹ See Rev Proc 2003-44, Section 6.10, 2003-23 IRB 1051.

Excess Amount

For purposes of the EPCRS, excess amount means one of the following:

1. An overpayment
2. An elective deferral returned to satisfy IRC Section 415
3. An elective deferral in excess of the IRC Section 402(g) limit
4. An elective deferral that is distributed to satisfy IRC Section 401(a)(17) (the compensation limit)
5. An amount contributed on behalf of an employee that is in excess of the employee's SEP benefit
6. An excess contribution that is distributed to satisfy IRC Section 408(k)(6)(A)(iii)
7. Any similar amount required to be distributed in order to maintain plan qualification

Overpayment

An overpayment under a SEP or SIMPLE IRA is a distribution to an employee or beneficiary that exceeds the employee's or beneficiary's benefit under the terms of the SEP or SIMPLE IRA because of a failure to comply with the compensation limit under IRC Section 401(a)(17) or the annual additions limit of the lesser of 25 percent of the participant's taxable compensation or \$41,000 (\$44,000 with catch-up contribution) under IRC Section 415 for 2004 or a payment to a SIMPLE IRA in excess of the employer's contribution maximum. An overpayment generally does not include a distribution of an excess amount.

Earnings

If a corrective allocation is made, it should be adjusted for earnings that would have been allocated to the participant's account if the violation had not occurred. There need not be an adjustment for losses, but such an adjustment is permitted. If the plan allowed for participant directed investments at the time of the failure, and, therefore, a number of different investments were permitted, the plan is permitted to use the highest rate earned in the plan for the year of the failure. This method is applicable if most of the affected participants are NHCEs.

Note. If actual investment results are unable to be determined, a special rule allows the sponsor of a SEP or SIMPLE IRA plan to use a reasonable rate of interest.⁴²

Corrective allocations for a prior plan year are considered an annual addition for the year to which the correction applies, not for the year in which the

⁴² Rev. Proc 2003-44, Section 6.04(b)(ii).

corrective allocations are made. The normal rules of IRC Section 404, however, apply for deduction purposes.⁴³ This means that the employer will generally not receive a deduction. Corrective allocations can come only from employer contributions.

To correct an operational failure under the VCP, an employer must do the following:

1. Satisfy submission requirements.
2. Correct the failure identified in accordance with the compliance statement.
3. Pay the required compliance fee.

Insufficient Information

The failure cannot be corrected under the VCP under the following conditions:

- It is not possible to obtain sufficient information to determine the nature or extent of a failure.
- There is insufficient information to effect proper correction.
- The application of the VCP for SEP would be inappropriate or impractical.

Amendment to Correct

If the failure includes the adoption of a permitted amendment (IRS model or prototype), the submission of the amendment with the appropriate fee and submission form should be sent simultaneously with the VCP application.

Application for Compliance Statement

Generally, the request under the program from the employer consists of a letter indicating the description of the failures, methods of correction, and any other procedural items. In the case of a VCP submission, the following is required:⁴⁴

1. A statement identifying the type of plan submitted
2. A description of the applicable correction and failures and the years in which the failures occurred
3. A description of the administrative procedures in effect at the time the failures occurred
4. An explanation of how and why the failures occurred
5. A description of the methodology that will be used to calculate earnings

⁴³ IRC Section 404(j).

⁴⁴ See Rev. Proc. 2003-44, Section 11, 2003-23 IRB 1051.

6. The method that will be used to locate and notify former employees and beneficiaries
7. A description of the measures that have been implemented to ensure that the same failures will not occur
8. A statement that neither the employer nor the plan is not under examination
9. A statement that the employer proposes to implement (or has implemented) the correction(s)
10. The information generally included on the first three pages of Form 5500, including the name and number of the plan and the employer's identification number (EIN) (The information is needed even if the plan is not subject to Form 5500 series filing requirements.)
11. A copy of the SEP or SIMPLE document
12. A copy of the most recent opinion letter for a prototype SEP or SIMPLE, or a copy of the IRS current Model SEP on Form 5305-SEP, Simplified Employee Pension Individual Retirement Accounts Contribution Agreement; or Form 5305A-SEP, Salary Reduction Simplified Employee Pension Individual Retirement Accounts; or a copy of the IRS current Model SIMPLE Plan on Form 5305-SIMPLE or 5304-SIMPLE
13. The initial VCP fee (\$500 for SEP or SIMPLE), which must be included with the submission
14. The signature the employer or their representative and the "penalty of perjury statement"

Corrections of Operation Failures

The following is a brief description of operational failures and corrections under the SCP and VCP for SEP and SIMPLE IRA. In each case, the method described corrects the operational failure identified. Corrective allocations and distributions should reflect earnings. The corrections listed are those that may work with a SEP or SIMPLE, although some need modification:

- *Failure to properly provide the minimum top-heavy benefit under IRC Section 416 to nonkey employees.* In a SEP (or SARSEP) plan, the permitted correction method is to properly contribute and allocate the required top-heavy minimums to the SEP IRA in the manner provided for in the plan on behalf of the nonkey employees (and any other employees required to receive top-heavy allocations under the plan).
- *Failure to satisfy the SARSEP ADP test.* The permitted correction method is to make qualified nonelective contributions (QNEC) (employer contribution) on behalf of the NHCEs to the extent necessary to raise the ADP of the NHCEs to the percentage needed to pass the

test.⁴⁵ The contributions must be made on behalf of all eligible NHCEs (to the extent permitted under IRC Section 415) and must either be the same flat dollar amount or the same percentage of compensation. The one-to-one correction method may also be used.

- *Deferral percentage test failures.* This method, also known as the one-to-one correction method, may be used. Under this method, there is a corrective distribution of excess contributions and an equivalent corrective contribution made to the plan which is allocated to NHCEs only.
- *Failure to distribute elective deferrals in excess of the IRC Section 402(g) limit.*⁴⁶ The permitted correction method for a SEP or SIMPLE is to distribute the excess deferral to the employee and to report the amount as taxable in the year of deferral and the year distributed. A distribution to an HCE is included in the ADP test; a distribution to a NHCE is not included in the ADP test. A distribution is reported as taxable on Form 1099-R for the year of the distribution. The employee is also required to amend their tax return for the year of the excess deferral and claim the excess on line 7 of their Form 1040.
- *Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years.* The permitted correction method is to make a contribution to the plan on behalf of the employees excluded from a SEP or SIMPLE IRA. If the employee should have been eligible to make an elective contribution under a SARSEP arrangement or SIMPLE IRA, the employer must make a QNEC to the plan on behalf of the employee that is equal to the ADP for the employee's group (either HCE or NHCE). Contributing the ADP for such employees eliminates the need to rerun the ADP test to account for the previously excluded employees.

The administrator may use a prorated amount for the excluded employee's compensation for the portion of the year that the employee was excluded.

Corrective contributions, with respect to the missed elective deferrals, are not required if an employee has been permitted to defer to the plan for a period of at least nine consecutive months during the plan year:

- *Failure to timely pay the minimum distribution required under IRC Section 401(a)(9).* In a SEP IRA or SIMPLE IRA, the permitted correction method is to distribute the required minimum distributions (RMDs). The amount to be distributed for each year in which the failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable divisor. For this purpose, adjusted account balance means the actual account bal-

⁴⁵ See, Treas. Reg. Section 1.401(k)-1(g)(13).

⁴⁶ In contravention of IRC Section 401(a)(30).

ance, determined in accordance with the proposed regulations, reduced by the amount of the total missed minimum distributions for prior years.

- *Failure to satisfy the IRC Section 415(c) limits in a defined-contribution plan.* The permitted correction for failure to limit annual additions (other than elective deferrals) allocated to participants in a SEP or SIMPLE plan as required in IRC Section 415(c) (even if the excess did not result from a reasonable error in estimating compensation) is to place the excess annual additions into an unallocated account, similar to the suspense account, to be used as an employer contribution in the succeeding year(s). Although such amounts remain in the unallocated account, the employer is not permitted to make additional contributions to the plan. The permitted correction for failure to limit annual additions that are elective deferrals (even if the excess did not result from a reasonable error in determining the amount of elective deferrals that could be made with respect to an individual under the IRC Section 415 limits) is to distribute the elective deferrals or employee contributions using a method similar to that described under the regulations.
- *Correction of exclusion of eligible employees in employer contribution to SEP and SIMPLE.* Additional nonelective contribution must be made on behalf of the excluded employee, adjusted for earnings. If, due to the additional contribution, there should be a reduction in another employee's contribution, no reduction is made. However, if the alternate reallocation method is used, the original contribution made is reallocated to include the excluded employee(s). This will require some employees to receive decreases in their account balances. If the aggregate amount of decreases exceeds the aggregate amount of increases, then the employer must make a nonelective contribution to the plan to take care of the difference.
- *Correction of IRC Section 415 failures.* There are two methods to correct excesses under IRC Section 415:
 - *Forfeiture correction method.* This method may be used for a NHCE who has an excess IRC Section 415 addition and has separated from service with no vested interest in the matching or nonelective contribution and has not been reemployed at the time of correction.
 - *Return of overpayment correction method.* The employer may take appropriate steps to have the employee return the overpayment (a *de minimis* rule of \$100 applies), plus earnings to the plan. The employer must also indicate to the employee who received the overpayment that such payment is eligible for neither rollover treatment nor favorable tax treatment.
- *Other overpayment failures.* SEP and SIMPLE overpayments are corrected under IRC Section 415(c) using the return of overpayment method described above. Revenue Procedure 2003-44 clarifies that if

the SEP IRA or SIMPLE retains the overpayment, the employer is subject to the 10-percent tax in addition to the VCP SEP submission fee.

- *Correction of IRC Section 401(a)(17) failures.* Under the reduction of account balance method, the account balance of an employee who received an allocation on the basis of compensation in excess of the IRC Section 401(a)(17) limit (\$41,000 for 2003 and 2004, plus catch-up elective deferrals) is reduced by the improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is re-allocated to those employees in accordance with the plan's allocation formula. A qualified plan can go further if the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account⁴⁷ to be used to reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated amount (adjusted for earnings) would be used to reduce future employer contributions. This second step is not available for SEP or SIMPLE.
- *Correction of inclusion of ineligible employee failure by plan amendment.* The plan may be amended retroactively to change the eligibility requirements to allow the ineligible employee to become eligible. All other employees who become eligible due to the amendment must be covered as well. Unfortunately, there are no SEP or SIMPLE examples in Revenue Procedure 2003-44.⁴⁸ Even though the IRS has added SEP and SIMPLE IRA to the EPCRS, additional guidance is needed. Furthermore, the VCP rules do address how an employer is to effectuate a distribution in the case of an IRA-based plan, especially if the employee is reluctant to do so. Employers are not parties to the IRA arrangements established by their employees, although that agreement is an integral part of the employer.

VCP Fees for SEP and SIMPLE IRA

The fee that applies under the VCP program for SEP and SIMPLE is generally \$500. In cases in which the employer is using its own correction method (and not one outlined by the IRS under Revenue Procedure 2003-44), the IRS will charge an (undisclosed) additional fee. Also, if the failure involves an excess amount that is retained in the SEP or SIMPLE IRA, a fee equal to at

⁴⁷ Similar to the suspense account described in the Treas. Reg. Section 1.415-6(b)(6)(iii).

⁴⁸ 2002-29 IRB 1.

least 10 percent of the excess amount excluding earnings will be imposed. The compliance fee for egregious failure may be a negotiated amount.⁴⁹

The group submission fees have been reduced to \$10,000 for the first 20 plans and \$250 for each additional plan, up to a maximum of \$50,000 (previously \$90,000). Finally, for all VCP requests, the fee must be submitted with the initial application and need not be paid in the form of a certified or cashier's check. Thus, the correction methods for SIMPLE IRA and SEP are very similar to those for qualified plans. For certain failures, however, Revenue Procedure 2003-44 provides specific correction methods and reporting requirements that are unique to the circumstances of SIMPLE IRA and SEP.

Note. Arguably, the plan sponsor (generally, the employer) is not retaining any *excess amount* in the SEP or SIMPLE IRA for purposes of the additional fee which is equal to at least 10 percent of the excess amount retained in the plan imposed when the plan sponsor “retains the Excess Amount.”⁵⁰

If there is a *de minimis* excess amount of \$100 or less attributable to elective deferrals or employer contributions, the plan sponsor is not required to distribute the excess amount and the special fee will not apply.⁵¹

DOL Voluntary Fiduciary Correction Program

Purpose of VFCP

The proposed VFC allows certain persons to avoid potential civil actions, penalties, the assessment of civil penalties under (Employee Retirement Income Security Act of 1974) ERISA. In general, the exemption affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.⁵² On November 25, 2002, the DOL issued a final class exemption to permit certain transactions identified in the proposed VFCP.⁵³ The IRS grants similar relief.⁵⁴

⁴⁹ Rev Proc 2003-44, Section 12.05(1)-(2); note the reference in Revenue Procedure 2003-44, Section 12.05(2), to Section “6.08(1)” should be corrected by replacing that reference with Section “6.10(1).” Additional fees may be imposed for egregious failures, Rev Proc 2003-44, Section 12.06

⁵⁰ Rev Proc 2003-44, Sections 6.10(5)(b), 12.05(2). Rather, such amounts are generally retained by the trustees and custodians of the prototype and model IRA document sponsor(s) of the IRA arrangements established by participating employees. The employer is not a party to the agreements establishing the SIMPLE IRAs and has neither dominion nor control over the assets in such an arrangement, nor does the plan sponsor have any control as to their investment or disposition. The plan sponsor is not authorized to order, direct, or to effectuate any distribution from the SIMPLE IRA accounts; all such rights in the account reside solely to the employee that established the account. Rarely is the plan sponsor the trustee or custodian of the assets held in the SIMPLE IRAs. On the other hand, if a “group or employer-sponsored” individual retirement arrangement under IRC Section 408(c) is used or there is a group or common trust, the plan sponsor would generally and more arguably be subject to the extra fee. Furthermore, in the case of an employer eligibility failure, the revenue procedure requires that “the assets in such plan are to remain in the trust, annuity contract, or custodial account” until a distribution event has occurred. See Rev Procedure 2003-44 Section 6.03(1).

⁵¹ Rev. Proc. 2003-44, Section 6.10(5)(c).

⁵² Adoption of Voluntary Fiduciary Correction Program, 67 Fed Reg 60, 15051-15060.

⁵³ PTE 2002-51 (App No D-10933. 67 Fed Reg 227, 70623-70628.

⁵⁴ IRS Ann. 2002-31, 2002-15 IRB 747.

The purpose of the VFCP is to protect the financial security of workers by encouraging the identification and correction of transactions that violate Part 4 of Title I of ERISA. Part 4 of Title I of ERISA sets out the responsibilities of employee benefit plan fiduciaries.

Section 409 of ERISA provides that a fiduciary who breaches any of these responsibilities shall be personally liable to make good to the plan any losses to the plan resulting from each breach and to restore to the plan any profits the fiduciary made through the use of the plan's assets.

Section 405 of ERISA provides that a fiduciary may be liable, under certain circumstances, for a fiduciary's breach of his or her fiduciary responsibilities. In addition, under certain circumstances, there may be liability for knowing participation in a fiduciary breach. In order to assist all affected persons in understanding the requirements of ERISA and meeting their legal responsibilities, the Employee Benefits Security Administration (EBSA), formerly the Pension and Welfare Benefits Administration (PWBA), provided guidance on what constitutes adequate correction under Title I of ERISA for the breaches described in the VFCP.

The VFCP also applies to a SEP, SARSEP, or SIMPLE IRA if the plan is subject to ERISA. SEP, SARSEP, and SIMPLE are subject to ERISA if there is at least one common-law employee participating in the plan.

Effect of the VFCP

In general, the EBSA will issue to the applicant a no-action letter with respect to a breach identified in the application of an eligible person or entity, and the breach is corrected. Pursuant to the no-action letter it issues, the EBSA will not initiate a civil investigation under Title I of ERISA regarding the applicant's responsibility for any transaction described in the no-action letter, or assess a civil penalty under ERISA Section 502(l) on the correction amount paid to the plan or its participants.

Eligible Transactions

The four eligible transactions described in the exemption are as follows:⁵⁵

1. The failure to timely transmit participant contributions.
2. The making of a loan by a plan at a fair-market interest rate to a party in interest with respect to the plan.
3. The purchase or sale of an asset (including real property) between a plan and a party in interest at fair market value (FMV).

⁵⁵ More specifically, the VFCP covers 14 financial transactions involving employee benefit plans, namely, (1) delinquent participant contributions to pension plans; (2) delinquent participant contributions to welfare plans; (3) fair market interest rate loans with parties in interest; (4) below market interest rate loans with parties in interest; (5) below market interest rate loans with nonparties in interest; (6) below market interest rate loans due to delay in perfecting security interest; (7) purchase of assets by plans from parties in interest; (8) sale of assets by plans to parties in interest; (9) sale and leaseback of property to sponsoring employers; (10) purchase of assets from nonparties in interest at below market value; (11) sale of assets to nonparties in interest at below market value; (12) benefit payments based on improper valuation of plan assets; (13) payment of duplicate, excessive, or unnecessary compensation; (14) payment of dual compensation to plan fiduciaries.

4. The sale of real property to a plan by the employer and the leaseback of such property to the employer, at FMV and fair market rental value, respectively.

If an application is rejected, the applicant may be subject to enforcement action, including assessment of civil monetary penalties under ERISA Section 502(l).

Fiduciary Correction Methods

The VFCP provides acceptable correction methods for the failures listed above. As part of the correction process, applicants must:

- Conduct valuations of plan assets using generally recognized markets for the assets or obtain written appraisal reports from qualified professionals that are based on generally accepted appraisal standards.
- Restore to the plan the principal amount involved, plus the greater of (1) the lost earnings starting on the date of the loss and extending to the recovery date, or (2) the profits resulting from the use of the principal amount for the same period.
- Pay the expenses associated with the correction process, such as appraisal costs or the cost of recalculating participant account balances.
- Make supplemental distributions to former employees, beneficiaries, or alternate payees when appropriate and provide proof of the payments.

Application Documentation

A VFCP applicant must submit the following documentation to the appropriate regional office of the EBSA, formerly the PWBA:

- Statement showing the plan has a current fidelity bond and the name of the company providing the bond and the policy number
- Copy of relevant portions of the plan and related documents
- Documents supporting transactions, such as leases and loan documents and applicable corrections
- Documentation of lost earnings amounts
- Documentation of restored profits
- Proof of payment of affected amounts
- Certain documents on affected transactions
- Signed checklist
- Penalty of perjury statement

Like an EPCRS applicant, a VFCP applicant must restore the plan, the participants, and their beneficiaries to the condition they would have been in

had the breach not occurred. Plans must also file, if necessary, amended returns to reflect corrected transactions or valuations.

Under the VFCP, applicants must also provide proof of payment to participants and beneficiaries or properly segregate affected assets if the plan is unable to locate missing individuals.

Payment of the correction amount may be made directly to the plan if distributions to separated participants would be less than \$20 and the cost of correction would exceed the distributions owed. Applicants can use the blended rate (in lieu of the highest rate) in calculating the rate of return on affected transactions involving ERISA Section 404(c) plans only for affected participants who have not made investment allocations.

Prohibited Transaction Excise Tax

In an effort to encourage use of the VFCP, the DOL proposed a class exemption providing limited relief from the excise taxes under IRC Section 4975 on transactions covered by the VFCP. The proposed exemption is with respect to transactions involving:

- Failure to timely remit participant contributions to plans⁵⁶
- Loans made at fair market interest rates by plans to parties in interest
- Purchases or sales of assets between plans and parties in interest at FMV
- Sales of real property to plans by employers and leaseback of the property, at FMV and fair market rental value, respectively

Under the exemption, a VFCP applicant must repay delinquent contributions to the plan no more than 180 days from the date the money was received by the employer or would be payable to plan participants in cash.

The exemption also requires the following:

- No more than 10 percent of the FMV of total plan assets may be involved (except for delinquent employee contributions).
- Notice of the transaction and the correction must be provided to interested persons.
- Transactions covered under the exemption cannot be part of an arrangement or understanding that benefits a related party.

The exemption does not apply to any transaction similar to a transaction for which an application has been submitted under the VFCP within the past three years.

⁵⁶ 29 C.F.R. Section 2510.3-102.

Additional VFCP Information

Additional information on the VFCP can be obtained by contacting the EBSA at (866) 275-7922 and requesting the VFCP coordinator. Questions about the proposed prohibited transaction exemption should be directed to the Office of Exemption Determinations at (202) 693-8540.⁵⁷

DOL Delinquent Filer Voluntary Compliance Program

The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The program gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount.⁵⁸ The acceptance of a filing and receipt of penalty payments does not represent a determination by the DOL as to the status or type of plan.⁵⁹

Eligibility

Eligibility for the DFVC Program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA.^{60, 61}

Program Criteria

Participation in the DFVC Program is a two-part process:⁶²

1. File a complete Form 5500 Series Annual Return/Report, including all schedules and attachments, for each year relief is requested to the EBSA.⁶³
2. Submit the required documentation and applicable penalty amount to the DFVC Program.

If the Form 5500 is being filed under the DFVC Program, check Form 5500, Part I, box D, and attach a statement explaining that the Form 5500 is

⁵⁷ For additional information, see EBSA's "Frequently Asked Questions about the Voluntary Fiduciary Correction Program" at http://www.dol.gov/ebsa/faqs/faq_vfcp.html.

⁵⁸ 67 Fed. Reg. 60, 15052 (March 28, 2002).

⁵⁹ The DFVC Notice was published in the Federal Register on March 28, 2002 (67 Fed. Reg. 60, Preamble at 15052, Notice at 15058). See Section 5.04.

⁶⁰ DFVC Notice Section 1, 67 Fed. Reg. 60 (March 28, 2002).

⁶¹ For example, Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVC Program because such plans are not subject to Title I.

⁶² DFVC Notice Section 3, 67 Fed. Reg. 60 (March 28, 2002).

⁶³ Special simplified rules apply to top-hat plans and apprenticeship and training plans.

being filed under the DFVC Program with “Form 5500, Box D—DFVC FILING” prominently displayed at the top of the statement.

Liability

The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVC Program shall not be paid from the assets of an employee benefit plan.⁶⁴

Penalty Structure⁶⁵

The basic penalty under the program is \$10 per day for delinquent filings. The maximum penalty for a single late annual report is \$750 for a small plan (generally, a plan with fewer than 100 participants at the beginning of the plan year) and \$2,000 for a large plan.

To encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years, there is a per plan cap limits of \$1,500 for a small plan and \$4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no per administrator or per sponsor cap. If the same person is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

A special per plan cap of \$750 applies to a small plan sponsored by an organization that is tax-exempt under IRC Section 501(c)(3). The \$750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if, as of the date the plan files under the DFVC Program, there is a delinquent annual report for a plan year during which the plan was a large plan.

The penalty amount for top-hat plans and apprenticeship and training plans is \$750.⁶⁶

Plan administrators may use the Form 5500 for the year relief is sought or the most current form available at the time of participation. This option allows administrators to choose the form that is most efficient and least burdensome for their circumstances.

Extension of Time to File

A one-time extension of time to file Form 5500 (up to two and one-half months) by filing Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, on or before the normal due date (not including any extensions) of the return/report. You *must* file Form 5558 with the IRS. A photocopy of the extension request that was filed must be attached to the Form 5500.

⁶⁴ DFVC Notice Section 3.04, 67 Fed. Reg. 60 (March 28, 2002).

⁶⁵ DFVC Notice Section 3.03, 67 Fed. Reg. 60 (March 28, 2002).

⁶⁶ DFVC Notice Section 4.02, 67 Fed. Reg. 60 (March 28, 2002).

An automatic extension of time to file Form 5500 until the due date of the federal income tax return of the employer will be granted if all of the following conditions are met:

1. The plan year and the employer's tax year are the same.
2. The employer has been granted an extension of time to file its federal income tax return to a date later than the normal due date for filing the Form 5500 (except IRS Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts).
3. A copy of the application for extension of time to file the federal income tax return is attached to the Form 5500.

An extension granted by using Form 5558 cannot be extended further by filing another Form 5558.

Abatement for Reasonable Cause

If a nonfiling penalty has already been assessed, it may be possible to have the penalty abated by establishing reasonable cause with the IRS.⁶⁷ For example, a request to have the penalties abated for reasonable cause might include the following:

An additional extension of time for the filing of Form 5500-C (and related schedules) is needed because circumstances beyond the taxpayer's control have prevented the proper compilation of data to the full extent necessary for the completion of the ____, ____ and ____ pages of the 200____ Form 5500. In order for the taxpayer to complete each of the questions in a manner which will most accurately relate the state of the plan in accordance with instructions issued jointly by the Internal Revenue Service and the Department of Labor, there is need to properly clarify and refine pertinent data thus far accumulated. So that the taxpayer may file the Annual Return/Report in a form which is no way incomplete nor otherwise insufficient, the taxpayer needs an extension of the filing deadline. Only with approval of the extension request will the taxpayer be able to proceed in a manner which will facilitate the proper realignment of all data in a manner fully consistent with the intent of ERISA.

[State the reasons, facts, and circumstances.]

On behalf of the plan, I respectfully request that an extension be granted and any late filing penalties be abated in light of the aforementioned facts and circumstances. I unhesitatingly believe that the taxpayer had reasonable cause sufficient to a person of ordinary prudence so as to warrant an abatement for reasonable cause in accordance with Internal Revenue Manual.

⁶⁷ IRM Part IV.

IRS and PBGC Participation

Although the DFVC Program does not cover late filing penalties under the Internal Revenue Code or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVC Program have been satisfied.⁶⁸

Additional Information

For additional information and questions about the DFVC Program, contact the EBSA at (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov, or call the EBSA help desk at (866) 463-3278.⁶⁹

⁶⁸ DFVC Notice Sections 5.02, 5.03, 67 Fed. Reg. 60 (March 28, 2002).

⁶⁹ For additional information on the DFVC, see DOL's "Frequently Asked Questions about the Delinquent Filer Voluntary Compliance Program" at http://www.dol.gov/ebsa/faqs/faq_dfvc.html.

Chapter 13

Required Minimum Distributions

By GREGORY KOLOJESKI, ESQ.
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Required Minimum Distributions

BY GREGORY KOLOJESKI, ESQ.
BRENTMARK SOFTWARE, INC.

On April 17, 2002, the Internal Revenue Service (IRS) issued the final regulations under Internal Revenue Code (IRC) Section 401(a)(9) for required minimum distributions (RMDs) from retirement plans.¹ The RMD rules apply to qualified plans under IRC Section 401(a), annuity contracts under IRC Section 403(a), individual plans under IRC Sections 408(a)(6) and 408(b)(3), including Roth individual retirement accounts or annuities (IRAs) under IRC Section 408A for certain purposes, and even certain deferred compensation plans under IRC Section 457(d)(2).² This chapter will examine the RMD rules for years after 2002, as they apply to qualified plans and IRAs (including Roth IRAs).

Introduction

RMDs are calculated on an annual basis once one reaches the age of 70½. A pension-plan balance as of December 31 of the prior year is divided by a life expectancy factor to arrive at a distribution amount or RMD for the required distribution year. The life expectancy factor is determined by the age on one's birthday in the required distribution year. Most of the complexity of the RMD rules relates to the complexity of determining the life expectancy factor. The table and the methodology that is used to determine the life expectancy factor depends on whether the plan owner is living or not, whether there is a beneficiary or not, and whether a beneficiary is the spouse or not—and this is coupled with a myriad of special rules and exceptions. It should be noted that the RMD rules relate to minimum amounts that must be distributed. Greater

¹ Treas. Reg. Section 1.401(a)(9).

² Treas. Reg. Section 1.401(a)(9)-1, A-1.

amounts may be distributed if needed without penalty if the plan owner is older than age 59½. If RMDs are not made, the potential penalty for not making the distribution is 50 percent of the RMD that should have been made.³

Lifetime Required Minimum Distributions

The rules for RMDs during one's lifetime are different than the rules for post-death distributions.

Required Beginning Date

Generally, the required beginning date is April 1 of the calendar year following the calendar year in which the plan owner attains age 70½.⁴

Example. John was born on May 1, 1934. He will attain age 70 on May 1, 2004, and will be age 70½ on November 1, 2004. His required beginning date is April 1, 2005. Mary was born on July 10, 1934. She will attain age 70 on July 10, 2004, and will be age 70½ on January 10, 2005. Her required beginning date is April 1, 2006. Each must make their first RMD by the required beginning date.

Employment Exception for Plans Other Than IRAs

For plan owners who do not own more than 5 percent of their company, the required beginning date is the later of April 1 of the calendar year following the calendar year in which the plan owner attains age 70½ or April 1 following the year in which the plan owner retires.⁵

"Uniform Lifetime Table"

For most plan owners (other than those falling under the spousal exception), the "Uniform Lifetime Table"⁶ (previously known as the "Minimum Distribution Incidental Benefits or MDIB Table"⁷) is used to find the life expectancy factor (referred to as the distribution period in the table) that is used to determine the RMD. The table will need to be used for each year the plan owner is alive. If the plan owner has a seventieth birthday in the year in which he turns 70½, a 27.4 factor from the "Uniform Life Table" is used for the first RMD year. If the plan owner has a seventieth-first birthday in the year in which he turns 70½, a 26.5 factor from the Uniform Life Table is used for the first RMD year.

³ IRC Section 4974(a).

⁴ Treas. Reg. Section 1.401(a)(9)-2, A-2.

⁵ Treas. Reg. Section 1.401(a)(9)-2, A-2(a).

⁶ Treas. Reg. Section 1.401(a)(9)-9, A-2.

⁷ Table of Applicable Divisors for the Minimum Distribution Incidental Benefit Rule in the 1987 Prop. Reg. §1.401(a)(9)-2, Q&A-4(a)(2).

Example. John was born on May 1, 1934, and will be age 70½ on November 1, 2004. In 2004, he will have a seventieth birthday. His first RMD will be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4 (which is the “Uniform Lifetime Table” distribution period value for age 70). Mary was born on July 10, 1934, and will be age 70½ on January 10, 2005. In 2005, she will have a seventieth-first birthday. Her first RMD will be based on a 12/31/2004 plan balance divided by a life expectancy factor of 26.5 (which is the “Uniform Lifetime Table” distribution period value for age 71).

Two RMDs in One Year

Since the first RMD does not need to be distributed until the required beginning date of April 1st, it is possible to have two RMDs in one year. Generally, it is not a good idea to take two RMDs in the same year as it may result in moving into a higher income tax bracket. After the first RMD, all RMDs must be distributed during the calendar year. An RMD may be distributed in one amount or in numerous partial amounts as long as the entire RMD amount is distributed during the appropriate time period.

Example. John was born on May 1, 1934, and his required beginning date is April 1, 2005. His first RMD will be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4. The first RMD must be distributed any time from January 1, 2004, through April 1, 2005. His second RMD will be based on a 12/31/2004 plan balance divided by a life expectancy factor of 26.5 and must be distributed from January 1, 2005, through December 31, 2005.

Spousal Exception

If the spouse is the sole beneficiary for the entire year and is more than ten years younger than the plan owner, the RMD is the longer of the appropriate factors⁸ from the “Uniform Lifetime Table”⁹ and the “Joint and Last Survivor Table.”¹⁰

Example. John was born on May 1, 1934, and will be age 70½ on November 1, 2004. In 2004, he will have a seventieth birthday. If he is not married, his first RMD would be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4 (which is the “Uniform Lifetime Table” distribution period value for age 70). Since his wife and sole beneficiary, Susan, was born on July 10, 1945 (which makes her more than ten years younger than her husband), he may use the longer life expectancy factor of 28.1 from the “Joint and Last Survivor Table.” The joint life expectancy, taken from the joint table for ages 70 and 59, is 28.1.

⁸ Treas. Reg. Section 1.401(a)(9)-5, A-4(b).

⁹ Treas. Reg. Section 1.401(a)(9)-9, A-2.

¹⁰ Treas. Reg. Section 1.401(a)(9)-9, A-3.

Roth IRA

Roth IRA owners are not subject to the RMD rules while they are living. They do not have to take distributions after attaining age 70½. However, Roth IRA beneficiaries (owners of inherited Roth IRAs) are subject to the RMD rules. For Roth IRAs, refer to the appropriate sections below for postdeath required distributions if the owner dies before the required beginning date. The Roth IRA final regulations state that the “minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date.”¹¹

Postdeath Required Distributions

After the death of the plan owner, RMD calculations depend on the type of beneficiary and sometimes on whether the plan owner died before or after the required beginning date. RMD calculations are based on the life expectancy of the designated beneficiary if there is one. The designated beneficiary is determined as of September 30 of the calendar year following the plan owner's death.¹² Generally, the designated beneficiary must be a beneficiary as of the date of death and must remain a beneficiary as of September 30 of the calendar year following the plan owner's death. In cases of multiple or contingent beneficiaries, it is possible for qualified disclaimers to be used to remove some of the beneficiaries before the September 30 date.

Postdeath Required Distributions: No Designated Beneficiary

Designated beneficiaries must be individuals. Certain beneficiaries are not considered to be designated beneficiaries. These include an estate, a charity, or beneficiaries of a nonqualifying trust. It is also possible to have no beneficiary. If there is no designated beneficiary, there is no life expectancy for the beneficiary and special rules will apply.

Year of Death. In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding discussion of lifetime RMDs.)¹³

Owner Dies Before Required Beginning Date

If the plan owner dies before the required beginning date and there is no designated beneficiary, the five-year rule applies.¹⁴ Under the five-year rule, the entire plan must be distributed by the end of the calendar year that contains the fifth anniversary of the plan owner's date of death.

¹¹ Treas. Reg. Section 1.408A-6, A-14(b).

¹² Treas. Reg. Section 1.401(a)(9)-4, A-4.

¹³ Treas. Reg. Section 1.401(a)(9)-2, A-5.

¹⁴ Treas. Reg. Section 1.401(a)(9)-3, A-4(a)(2).

Example. The plan owner dies on February 1, 2005, with no designated beneficiary. The fifth anniversary of the date of death is February 1, 2010. Therefore, the entire plan balance must be distributed by December 31, 2010.

Owner Dies On or After Required Beginning Date

If the plan owner dies on or after the required beginning date and there is no designated beneficiary, RMDs are taken over a term based on the plan owner's life expectancy in the year of death.¹⁵ The factors used in the RMD calculations are not taken directly from any table, but are based on the life expectancy factor in the "Single Life Table"¹⁶ as of the plan owner's year of death. The "Single Life Table" life expectancy for the year of death is obtained, and one is subtracted for each year after the year of death.¹⁷

Example. John was born on May 1, 1934. His required beginning date is April 1, 2005. He dies on June 30, 2005. In 2005, his life expectancy factor for RMD distributions is 26.5 and is taken from the "Uniform Lifetime Table." In the year he died (2005), his life expectancy factor from the "Single Life Table" was 16.3. In 2006, his life expectancy factor for RMD calculations is 15.3. For future RMD calculations, his life expectancy factor will be 14.3 in 2007, 13.3 in 2008, etc., until it reaches 0.3 in 2021 and the entire plan must be distributed.

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.¹⁸ For Roth IRAs, the first RMD must be made by December 31 of the appropriate year. If there is no designated beneficiary, the five-year rule will apply.¹⁹ Under the five-year rule, the entire plan must be distributed by the end of the calendar year that contains the fifth anniversary of the plan Roth IRA owner's date of death.

Postdeath Required Distributions: Nonspousal Beneficiary

In this case, there is a qualified designated beneficiary who is not the plan owner's spouse. Such individuals may be relatives or nonrelatives or certain qualifying trust beneficiaries.

Year of Death

In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding section entitled "Lifetime Required Minimum Distributions.")²⁰

¹⁵ Treas. Reg. Sections 1.401(a)(9)-5, A-5(a)(2) and 1.401(a)(9)-5, A-5(c)(3).

¹⁶ Treas. Reg. Section 1.401(a)(9)-9, A-1.

¹⁷ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(3).

¹⁸ Treas. Reg. Section 1.408A-6, A-14(b).

¹⁹ Treas. Reg. Section 1.401(a)(9)-3, A-4(a)(2).

²⁰ Treas. Reg. Section 1.401(a)(9)-2, A-5.

Owner Dies Before Required Beginning Date

For a nonspousal beneficiary in cases in which the owner dies before the required beginning date, the distribution period is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the plan owner's death*.²¹ The "Single Life Table" is used to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the plan owner's year of death. This is unlike the case in which there is no designated beneficiary and the plan owner dies on or after the required beginning date. In those cases, the first distribution in the year after the plan owner's date of death is a life expectancy *for the year of death minus one*. If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.²²

Example. John, the plan owner, was born on June 1, 1935. He dies on June 30, 2005, which is prior to his required beginning date of April 1, 2006. His designated beneficiary, Robert, was born on May 1, 1934. Robert will have his 72nd birthday in 2006. In 2006, Robert's life expectancy factor from the "Single Life Table" is 15.5. For future RMD calculations, his life expectancy factor will be 14.5 in 2007, 13.5 in 2008, etc., until it reaches 0.5 in 2021 and the entire plan must be distributed.

Owner Dies On or After Required Beginning Date

For a nonspousal beneficiary in cases in which the owner dies on or after the required beginning date, the distribution period is the longer of the beneficiary's life expectancy or the plan owner's life expectancy.²³ The beneficiary's life expectancy is the distribution period determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the plan owner's death*.²⁴ The "Single Life Table" is used to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the plan owner's year of death. The plan owner's life expectancy is based on the life expectancy factor in the "Single Life Table" *for the plan owner's year of death*. The "Single Life Table" life expectancy for the year of death is obtained and one is subtracted for each year after the year of death.²⁵ As a practical manner, the beneficiary's life expectancy will be used if the beneficiary is younger than the plan owner. In the more unlikely case in which the beneficiary is older than the plan owner, the plan owner's life expectancy may be greater and would then be the one used.

²¹ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c).

²² Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

²³ Treas. Reg. Section 1.401(a)(9)-5, A-5(a)(1).

²⁴ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(1).

²⁵ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(3).

Example. John, the plan owner, was born on June 1, 1935. He dies on June 30, 2007, which is after his required beginning date of April 1, 2006. His designated beneficiary, Robert, was born on May 1, 1934. Robert will have his 74th birthday in 2008. In 2008, Robert's life expectancy factor from the "Single Life Table" is 14.1. John has a 72nd birthday in 2007. For 2007, John's life expectancy factor from the "Single Life Table" is 15.5. In 2008, John's life expectancy would be 15.5 minus 1, or 14.5. Since 14.5 is longer than 14.1, 14.5 is the life expectancy used for calculating the 2008 RMD. A similar process leads to 13.5 for 2009 until 0.5 is used for 2022.

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.²⁶ For a nonspousal beneficiary, the distribution period is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the Roth IRA owner's death*.²⁷ The "Single Life Table" is used to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the Roth IRA owner's year of death. If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.²⁸

Postdeath Required Distributions: Spouse as Beneficiary

There are special rules that apply if the plan owner's sole beneficiary is the surviving spouse. For IRAs, a spouse can optionally elect to treat the plan as one's own (i.e., a spousal rollover) rather than remain as the beneficiary. Before looking at the spousal rollover, we will review the distribution rules for when the spouse remains as the beneficiary.

Year of Death

In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding discussion of lifetime RMDs.)²⁹

Owner Dies Before Required Beginning Date and Spouse Remains the Beneficiary

For a spousal beneficiary in cases in which the owner dies before the required beginning date, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of the plan owner's death*. The "Single Life Table" is used with all years taken directly from the table³⁰ (unlike nonspousal beneficiaries who use a value from the table and

²⁶ Treas. Reg. Section 1.408A-6, A-14(b).

²⁷ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c).

²⁸ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

²⁹ Treas. Reg. Section 1.401(a)(9)-2, A-5.

³⁰ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

then subtract one for each future year). However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.³¹ The spouse also has a special rule for when RMDs must start. The first year of distributions will be the later of end of the calendar year following the year in which the plan owner died or the end of the calendar year in which the plan owner would have attained age 70½.³² If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.³³

Example. John, the plan owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. John dies in 2005 and his wife remains his beneficiary. The first year of distributions is the later of the year after John died, 2006, or the year in which John would have been 70½, or 2014. The first RMD is in 2014 using a "Single Life Table" value of 21.8, which is the life expectancy factor for a person who is 64 (Susan's age in 2014). In 2015, the life expectancy is also taken from the table and is 21.0. If Susan dies in 2037, the life expectancy factor from the table for age 87, or 6.7, is used. In 2038, the life expectancy factor is 6.7 minus 1 or 5.7. The life expectancy factor drops to 0.7 in 2043, at which time the entire plan balance must be distributed.

Owner Dies On or After Required Beginning Date and Spouse Remains the Beneficiary

For a spousal beneficiary in cases where the owner dies after the required beginning date, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of the plan owner's death*. The "Single Life Table" is used with all years taken directly from the table³⁴ (unlike nonspousal beneficiaries who use a value from the table and then subtract one for each future year) as long as the spouse is living. However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.³⁵

Example. John, the plan owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. John dies in 2016 with John already having started taking RMDs. His wife remains

³¹ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

³² Treas. Reg. Section 1.401(a)(9)-3, A-3(b).

³³ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

³⁴ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

³⁵ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

his beneficiary. The RMD calculation in 2016 will use a “Uniform Lifetime Table” value based on John’s age of 72 or 25.6. The RMD calculation in 2017 will use a “Single Life Table” value based on Susan’s age of 67 in 2017 or 19.4. If Susan dies in 2037, the life expectancy factor from the table for age 87, or 6.7, is used. In 2038, the life expectancy factor is 6.7 minus 1 or 5.7. The life expectancy factor drops to 0.7 in 2043, at which time the entire plan balance must be distributed.

Spousal Rollover of IRA

The spouse of a beneficiary may elect to treat the IRA as her own IRA.³⁶ This can be accomplished by directly transferring the IRA to the spouse’s IRA or by retitling the IRA in the spouse’s name. This may be done any time after the death of original IRA owner and it would be important for the spouse to select beneficiaries. Generally, a spousal rollover is considered to be the best choice rather than remaining as a spousal beneficiary. However, there are several cases in which it may be desirable not perform a spousal rollover. If the surviving spouse is under 59½ years of age and may want to make withdrawals from the IRA before she reaches age 59½, she could avoid the 10-percent penalty for early withdrawals because IRA beneficiaries are not subject to the 10-percent penalty. Also, in cases in which the spousal beneficiary is much older than an IRA owner who was not yet 70½, distributions could be delayed if there is no spousal rollover.

Example. John, an IRA owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. They have a son named Jason born on March 1, 1975. John dies in 2016 with John already having started taking RMDs. Rather than remaining as a spousal beneficiary, Susan performs a spousal rollover in 2016 to become the new owner of the IRA and names Jason as the beneficiary. An RMD is required in 2016 using John’s age 72, or 25.6, from the “Uniform Lifetime Table.” No RMDs are required in 2017, 2018, or 2019. Susan’s first RMD is for 2020 (and may be taken as late as April 1, 2021) based on a factor of 27.4 (taken from the “Uniform Lifetime Table” for age 70). If Susan dies in 2037, the life expectancy factor from the table for age 87, or 13.4, is used. In 2038, the life expectancy factor is 22.7 (the “Single Life Table” value for Jason at age 63). In 2039, the factor is reduced by one to 21.7. The life expectancy factor drops to 0.7 in 2060, at which time the entire plan balance must be distributed when Jason is age 85. Had Susan remained as the spousal beneficiary, the entire plan would have been required to be distributed by 2043.

³⁶ Treas. Reg. Section 1.408-8, A-5.

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.³⁷ For a spousal beneficiary of a Roth IRA, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of the plan Roth IRA owner's death*. The "Single Life Table" is used with all years taken directly from the table³⁸ (unlike nonspousal beneficiaries who use a value from the table and then subtract one for each future year). However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.³⁹ The spouse also has a special rule for when RMDs must start. The first year of distributions will be the later of the end of the calendar year following the year in which the plan owner died or the end of the calendar year in which the plan owner would have attained age 70½.⁴⁰ The spouse of a beneficiary may elect to treat the Roth IRA as her own Roth IRA (see the preceding discussion of spousal rollover of an IRA).⁴¹ If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.⁴²

Future Changes to the RMD Rules

Like all areas of the tax law, future changes to the rules for RMDs are likely. In 2003, a pension bill was introduced that would increase the age required for RMD distributions and that would allow spousal rollovers of IRA at any time (rather than just after the death of the original owner of the IRA). The life expectancy tables used for RMD calculations are revised at least every ten years with another revision due by 2012. The NewRMD.com web site at www.newrmd.com is one source of information for legislative proposals and any actual legislative or regulatory changes.

Extracts of Treasury Regulations

Treasury Regulations Section 1.401(a)(9)-9— Life Expectancy and Distribution Period Tables

Q-1. What is the life expectancy for an individual for purposes of determining required minimum distributions under IRC Section 401(a)(9)?

A-1. The following table, referred to as the "Single Life Table," is used for determining the life expectancy of an individual.

³⁷ Treas. Reg. Section 1.408A-6, A-14(b).

³⁸ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

³⁹ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

⁴⁰ Treas. Reg. Section 1.401(a)(9)-3, A-3(b).

⁴¹ Treas. Reg. Section 1.408-8, A-5.

⁴² Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

Single Life Table

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	29	54.3	58	27.0	87	6.7
1	81.6	30	53.3	59	26.1	88	6.3
2	80.6	31	52.4	60	25.2	89	5.9
3	79.7	32	51.4	61	24.4	90	5.5
4	78.7	33	50.4	62	23.5	91	5.2
5	77.7	34	49.4	63	22.7	92	4.9
6	76.7	35	48.5	64	21.8	93	4.6
7	75.8	36	47.5	65	21.0	94	4.3
8	74.8	37	46.5	66	20.2	95	4.1
9	73.8	38	45.6	67	19.4	96	3.8
10	72.8	39	44.6	68	18.6	97	3.6
11	71.8	40	43.6	69	17.8	98	3.4
12	70.8	41	42.7	70	17.0	99	3.1
13	69.9	42	41.7	71	16.3	100	2.9
14	68.9	43	40.7	72	15.5	101	2.7
15	67.9	44	39.8	73	14.8	102	2.5
16	66.9	45	38.8	74	14.1	103	2.3
17	66.0	46	37.9	75	13.4	104	2.1
18	65.0	47	37.0	76	12.7	105	1.9
19	64.0	48	36.0	77	12.1	106	1.7
20	63.0	49	35.1	78	11.4	107	1.5
21	62.1	50	34.2	79	10.8	108	1.4
22	61.1	51	33.3	80	10.2	109	1.2
23	60.1	52	32.3	81	9.7	110	1.1
24	59.1	53	31.4	82	9.1	111+	1.0
25	58.2	54	30.5	83	8.6		
26	57.2	55	29.6	84	8.1		
27	56.2	56	28.7	85	7.6		
28	55.3	57	27.9	86	7.1		

Q-2. What is the applicable distribution period for an individual account for purposes of determining required minimum distributions during an employee's lifetime under section 401(a)(9)?

A-2. The following table, referred to as the "Uniform Lifetime Table," is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's spouse is either not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee.

Uniform Lifetime Table

Age of Employee	Distribution Period	Age of Employee	Distribution Period
70	27.4	92	10.2
71	26.5	93	9.6
72	25.6	94	9.1
73	24.7	95	8.6
74	23.8	96	8.1
75	22.9	97	7.6
76	22.0	98	7.1
77	21.2	99	6.7
78	20.3	100	6.3
79	19.5	101	5.9
80	18.7	102	5.5
81	17.9	103	5.2
82	17.1	104	4.9
83	16.3	105	4.5
84	15.5	106	4.2
85	14.8	107	3.9
86	14.1	108	3.7
87	13.4	109	3.4
88	12.7	110	3.1
89	12.0	111	2.9
90	11.4	112	2.6
91	10.8	113	2.4
92	10.2	114	2.1
93	9.6	115+	1.9

Final Roth IRA Regulations Pertaining to Minimum Distributions

Treasury Regulations Section 1.408A-6—Distributions

Q-14. What minimum distribution rules apply to a Roth IRA?

A-14. There are three aspects to the minimum distribution rules that apply to a Roth IRA:

1. No minimum distributions are required to be made from a Roth IRA under IRC Sections 408(a)(6) and (b)(3), which generally incorporate the provisions of IRC Section 401(a)(9), while the owner is alive. The postdeath minimum distribution rules under IRS Section 401(a)(9)(B) that apply to traditional IRAs, with the exception of the at-least-as-rapidly rule described in IRC Section 401(a)(9)(B)(i), also apply to Roth IRAs.
2. The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own.
3. Distributions to a beneficiary that are not qualified distributions will be includible in the beneficiary's gross income according to the rules in A-4 of this section.

Q-15. Does IRC Section 401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?

A-15. Yes. An individual required to receive minimum distributions from his or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA. Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from a traditional or SIMPLE IRA. In addition, an individual required to receive minimum distributions as a beneficiary under a Roth IRA can only satisfy the minimum distributions for one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.⁴³

⁴³ CFR, Title 26, Volume 5, Revised as of April 1, 2002. 26CFR1.408A-6 [Page 461-467]. www.access.gpo.gov/nara/cfr/waisidx_02/26cfr1v5_02.html.

Chapter 14

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Taxation of Retirement Plan Distributions

The federal tax rules applicable to pre- and postretirement distributions from qualified and nonqualified plans of deferred compensation are discussed in this chapter. The 10-year forward tax-averaging method for individuals born before 1936, the 20-percent capital gains treatment with respect to pre-1974 participation, and the exclusion of net unrealized appreciation in distributed employer securities are discussed in this chapter. The premature distribution penalty tax and exceptions from the penalty tax are also discussed. Required minimum distributions (RMDs) are discussed in Chapter 13, “Required Minimum Distributions.” Nonqualified deferred compensation plans are discussed in Chapter 25, “Nonqualified Deferred Compensation.”

IRA-Based Plans

SIMPLE IRA Distributions

In general, all distributions (including gain) from a savings incentive match plan for employees, individual retirement accounts or annuities (SIMPLE IRA) are taxable as ordinary income when withdrawn from the SIMPLE IRA and are taxed as ordinary income. The same rules that apply to traditional IRAs also apply to SIMPLE IRAs. If distributions are before age 59½, the amount received may also be subject to a 10-percent or 25-percent penalty.¹ A special rule applies to a payment or distribution received from a SIMPLE IRA during the two-year period beginning on the date on which the individual first participated in the SIMPLE IRA plan (the two-year period). If the penalty tax on early distributions applies to a distribution within the two-year period, the tax increases from 10 percent to 25 percent.² If another exception to the pen-

¹ Internal Revenue Code (IRC or the Code) Section 72(t), 408(d)(1), 408(p)(1).

² IRC Section 72(t)(6).

alty tax applies (see below), neither the 10- nor 25-percent penalty taxes apply. The RMD rules apply to SIMPLE IRAs.

The trustee or custodian is required to report distribution amounts to the IRS on Form 1099-R and to provide a copy of the form to the owner of the SIMPLE IRA. The usual IRA withholding rules apply.

SEP IRA Distributions

In general, all distributions (including gain) from a simplified employee pension plan (SEP) IRA are taxable when withdrawn from the SEP IRA and are taxed as ordinary income. Distributions of SEP contributions (including gain) are taxed in the same manner as traditional IRA distributions. Distributions are subject to federal income tax except to the extent of any basis attributable to nondeductible contributions. Distributions made prior to age 59½ may be subject to a 10-percent premature distribution penalty tax unless an exception applies. Other rules may apply to salary-reduction or elective SEP (SARSEP) distributions and the removal of excess contributions. The RMD rules apply to SEP IRAs.

Recognizing Losses in an IRA

If there is an investment loss in a traditional IRA or SIMPLE IRA, the loss can be recognized (included) on the federal income tax return, but only when all assets in all traditional IRA accounts and SIMPLE IRA accounts have been fully distributed and the total distributed is less than the unrecovered basis, if any.³ The basis in an IRA is the total amount of the nondeductible contributions made to all traditional and SIMPLE IRAs. The loss is claimed as a miscellaneous itemized deduction, subject to the 2 percent of adjusted gross income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

Example. Scotty has made nondeductible contributions to a traditional IRA totaling \$2,000, giving him a basis at the end of 2002 of \$2,000. By the end of 2003, his IRA earns \$400 in interest income. In that year, Scotty receives a distribution of \$600 (\$500 basis + \$100 (\$600 – (\$2,000 / \$2,400 × \$600)) interest), reducing the value of his IRA to \$1,800 (\$2,000 + \$400 – \$600) at year's end. In 2004, Scotty's IRA has a loss of \$500. At the end of that year, Scotty's IRA balance is \$1,300 (\$1,800 – 500). Scotty's remaining basis in his IRA is \$1,500 (\$2,000 – 500). Scotty receives the \$1,300 balance remaining in the IRA. He can claim a loss for 2004 of \$200 (the \$1,500 basis minus the \$1,300 distribution of the IRA balance).

³ Roth IRAs have separate basis recovery rules, but the method of computing a loss is the same. Form 8606 is correct, however, Publication 590 (for 2003, page 38) regarding loss recognition is poorly worded, especially in light of the definition of a traditional IRA on page 7, which states that a "traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA." In a Roth IRA, basis is total amount of the contributions made to the Roth IRA.

Note. Basis in a traditional IRA could potentially be attributable to a distribution that actually came from a SIMPLE IRA plan account. The rules for determining the pro-rata amount compare the basis in all traditional IRAs versus the balance in all traditional IRAs, including both SEP IRAs and SIMPLE IRA plan accounts. Thus, theoretically, a distribution from a SIMPLE could include basis, even though no after-tax monies were ever contributed to the SIMPLE, assuming there was basis from nondeductible contributions and/or a rollover of after-tax monies to a traditional IRA account.

Example. Worf made nondeductible contributions to a traditional IRA totaling \$2,000 in earlier years, giving him a basis at the end of 2003 of \$2,000. (Assume no gain.) Worf's employer maintains a SIMPLE IRA into which \$4,000 has been contributed; he withdraws \$1,000 on December 31, 2003, from the SIMPLE IRA, leaving a balance in the SIMPLE IRA of \$3,000. \$333.33 of the \$1,000 distributed from the SIMPLE IRA is treated as a return of basis (attributable to the traditional IRA). Thus, only \$666.67 is taxable ($\$1,000 - (\$2,000 / (\$2,000 + \$3,000 + \$1,000) * \$1,000)$). Worf's remaining basis in the traditional IRA is now \$1,666.67 ($\$2,000 - \333.33). In 2004, Worf withdraws \$5,000 from the remaining amount in all of his IRA-based accounts. Again, assume no gain. He will have to report \$3,333.33 ($\$5,000 - \$1,666.67$) as taxable income.

457 Plan Distributions

Eligible Governmental 457 Plan

For distributions made after December 31, 2001, amounts deferred under an eligible Internal Revenue Code (IRC or the Code) Section 457 (governmental 457 plan), and any income attributable to such amounts, are includable in the participant's gross income for the taxable year in which they are paid to the participant or the participant's beneficiary.⁴ The RMD rules apply to 457 plans.

Note. For distributions made before January 1, 2002, from such plans, any amounts deferred under an eligible 457 plan (and any income attributable thereto) were includable in the participant's gross income for the taxable year in which paid or otherwise made available to the participant (or beneficiary).⁵

Eligible Nongovernmental 457 Plans

Distributions of amounts deferred under eligible 457 plans sponsored by nongovernmental tax-exempt organizations are includable in the participant's gross income for the taxable year in which they are made available to the participant or the participant's beneficiary, without regard to whether they have

⁴ IRC Section 457(a)(1)(A); Treas. Reg. Section 1.457-7(b)(1).

⁵ IRC Section 457(a), prior to amendment by EGTRRA 2001; See Ltr. Rul. 9443015.

actually been distributed.⁶ Such amounts are not considered to be available simply because the participant or beneficiary is permitted to choose among various investments for amounts deferred under the plan.⁷ The use of a rabbi trust should not affect the tax treatment of participants or their beneficiaries.⁸

Ineligible 457 Plans

Compensation deferred under an ineligible 457 plan generally is includable in gross income in the first taxable year during which it is not subject to a “substantial risk of forfeiture.”⁹ If no substantial risk of forfeiture exists in the initial year of deferral, all compensation deferred under the plan must be included in the participant’s gross income for that year. The use of a rabbi trust plan does not affect the tax treatment of amounts deferred under an ineligible 457 plan.¹⁰

A participant’s right to deferred compensation under an ineligible 457 plan is subject to a substantial risk of forfeiture if it is conditioned on the future performance of substantial services by any individual.¹¹ Distributions from an ineligible plan are taxed according to the annuity rules.¹²

If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includable in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and, thus, will not be includable in income until paid to the participant or beneficiary.¹³

Premature Distributions

The 10-percent premature distribution tax may apply to rollovers (by direct transfer) from other plan types that are later distributed under the 457 plan.

Tax-Sheltered Annuities

Payments received are taxable to the employee, except to the extent the amounts are a recovery of the employee’s investment in the contract or to the extent the employee rolls over an eligible distribution to another tax sheltered annuity, a qualified plan, an eligible governmental 457 plan, or a traditional IRA. In general, if an annuity contract without life insurance protection is

⁶ IRC Section 457(a)(1)(B); Treas. Reg. Section 1.457-7(c)(1).

⁷ Treas. Reg. Section 1.457-7(c)(1).

⁸ See, Ltr. Ruls. 9517026, 9436015.

⁹ IRC Section 457(f)(1)(A); Treas. Reg. Section 1.457-11(a)(1).

¹⁰ See, Ltr. Ruls. 200009051, 9713014, 9701024, 9444028, 9430013, 9422038.

¹¹ IRC Section 457(f)(3)(B); Treas. Reg. Section 1.83-3(c).

¹² IRC Section 457(f)(1)(B); Treas. Reg. Section 1.457-11(a)(4).

¹³ Treas. Reg. Section 1.457-9.

used for funding plan benefits, all payments received are normally taxable in full as ordinary income to the employee.¹⁴ The 10-percent premature distribution tax may apply if the individual is under age 59½, unless an exception applies.

If the IRC Section 403(b) annuity contract or custodial account is solely liable for the payment of investment expenses, the direct payment of investment adviser fees from a participant's annuity or account is not treated as a distribution. (See Letter Rulings 9332040, 9316042, 9047073, and 9845003.)

Excess Contributions to Custodial Accounts

Contributions to a custodial account for the purchase of regulated investment company stock (mutual funds) may be subject to a 6-percent tax (not to exceed 6 percent of the value of the account). This penalty does not apply to a 403(b) plan funded with annuity contracts.

Premature Distributions

If an individual receives a premature distribution from a tax-sheltered annuity, his or her tax will be increased by 10 percent of the portion of the distribution includable in income.¹⁵

Qualified Plans

Distributions to participants are taxed as ordinary income when received, with the exception of the return of the principal amount of nondeductible voluntary employee contributions.¹⁶ There are certain situations, however, in which the participant may be eligible for favorable tax treatment. If a distribution or distributions are received from a qualified plan in the form of a lump-sum distribution, and no portion of which is rolled over to an IRA, special tax treatment may include:

- A 20-percent capital gains treatment with respect to pre-1974 participation¹⁷
- The 10-year forward tax averaging for individuals born before 1936¹⁸
- The exclusion of net unrealized appreciation in distributed employer securities discussed¹⁹

¹⁴ IRC Section 403(b)(1).

¹⁵ IRC Section 72(t).

¹⁶ IRC Section 402(a).

¹⁷ Tax Reform Act of 1986 (TRA 860, Section 1122(h)(3)).

¹⁸ TRA 86, Section 1122(h)(5); Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88), Section 1011A(b)(15)(B).

¹⁹ IRC Sections 402(e)(4).

Life Insurance Protection

The cost of life insurance protection provided under a qualified pension, annuity, or profit-sharing plan must be included in the employee's gross income for the year in which deductible employer contributions or trust income is applied to purchase life insurance protection.²⁰ It does not matter whether the insurance is provided under group permanent or individual cash value life insurance policies or term insurance, and whether it is provided under a trustee or nontrustee plan.²¹

Lump-Sum Distributions From Qualified Plans

Favorable tax treatment is available only to participants and beneficiaries who receive a lump-sum distribution from qualified plans. A lump-sum distribution is a distribution within one taxable year of the entire balance to the credit of the individual from all plans of the same type and the distribution is received due to one of the following:

1. The participant's death
2. Disability (applies only to self-employed individuals²²)
3. Separation of service (does not apply to self-employed individuals)
4. The participant attaining age 59½

Lump-sum treatment is not available to a participant who receives periodic payments and subsequently receives a single-sum payment.

Alternate Payee Under a Qualified Domestic Relations Order

Amounts paid to an alternate payee who is a spouse or former spouse pursuant to a qualified domestic relations order (QDRO) is eligible for lump-sum treatment so long as such alternate payee receives the balance to his or her credit under the plan and such amount is received within one taxable year.²³

Tax Credit ESOPs

Prior to 1987, there were two other forms of ESOPs, namely, the Tax Reduction Act stock ownership plan (TRASOP) and the payroll stock ownership plan (PAYSOP).

The Tax Reduction Act of 1975 allowed employers an additional 1 percent tax credit for a contribution of employer securities to a TRASOP equal to 1 percent of the employer's qualified investment in property for the year. See IRC Section 48(n) (repealed).

²⁰ IRC Section 72(m)(3)(B); Treas. Reg. Section 1.72-16(b).

²¹ Treas. Regs. Sections 1.402(a)-1(a)(3), 1.403(a)-1(d).

²² See IRC Section 401(c)(1).

²³ IRC Section 402(e)(4)(D)(i).

An additional ½-percent tax credit was allowed by later legislation for a contribution of employer securities to a TRASOP equal to employee contributions of up to ½ percent of the employer's qualified investment in property for the year (the matching employee plan percentage).

The Economic Recovery Tax Act of 1981 (ERTA) replaced the TRASOP with the PAYSOP, which provided a tax credit of ½ percent based on the compensation of participants in the PAYSOP paid after December 31, 1982. See IRC Section 41 (repealed). The PAYSOP was repealed by the Tax Reform Act of 1986 (TRA 86) for compensation paid or accrued after December 31, 1986.

Plan Types

The aggregation of similar plans applies in determining whether or not a lump-sum distribution exists. The three classes of qualified plans for this purpose are pension plans, profit-sharing and stock bonus plans.²⁴

Following is a chart of similar plans for this aggregation rule:

All Pension Plans	All Profit-Sharing Plans	All Stock Bonus Plans
All Defined-Benefit Plans, and Money-Purchase Pension and Target-Benefit Defined-Contribution Plans	Profit-Sharing, Thrift Incentive, and 401(k) Plans	Employee Stock Ownership Plans, TRASOPs, and PAYSOPS

“Separation From Service” Versus “Severance From Employment”

There is a difference between a “separation from service” for purposes of lump-sum distribution treatment and a “severance from employment” that is required prior to receiving a distribution from a qualified pension plan.²⁵ A pension plan (money-purchase and defined-benefit) may be disqualified if it permits distributions prior to “severance from employment” (e.g. retirement, disability, and death).²⁶ For tax purposes, one of the lump-sum distribution treatment events requires a “separation from service.” For example, in order for a 45-year-old participant, who is not disabled, to elect 10-year averaging, he or she must be “separated from service.”

Severance From Employment (for Purposes of a Distributable Event)

A *severance from employment* is made on the basis of whether or not the employee *continues to be employed* by the employer maintaining the plan. Furthermore, note the following:

²⁴ IRC Section 402(e)(4)(D).

²⁵ GCM 39824 (Aug. 27, 1990).

²⁶ Treas. Reg. Section 1.401-1(b)(1)(i).

- All employers required to be aggregated under the controlled group and affiliated service group rules are considered as one employer.²⁷
- If a new employer (not part of a controlled group or affiliated service group) either maintained a qualified plan and employees of the prior employer transfer assets from the prior plan, the employee does not incur a “severance from employment.”
- If the new or successor employer decides to maintain the prior employer’s plan, all employees are treated as not having incurred a “severance from employment,” even if such new employer is not required to be aggregated under the controlled group rules.
- No severance of employment occurs when a new employer is substituted as the sponsor of the former employer’s plan, and each participant immediately after the transfer is entitled to a benefit equal or greater than the benefit he would have been entitled to before the transfer.
- If a parent company sells the stock of a subsidiary, resulting in loss of control, a “severance from employment” may occur if:
 - The pension plan continues to be maintained by the parent and not by the subsidiary’s new owner.
 - No assets or liabilities are transferred to the new owners of the subsidiary (including all employers required to be aggregated under the controlled group and affiliated service group rules).
 - The new owner of the subsidiary is not required to be aggregated under the controlled group or affiliated service group rules.

Separation From Service (for Purposes of a Lump-Sum Distribution)

A *separation from service* is made on the basis of whether or not the employees continue to work on the same job for a different employer as a result of liquidation, merger, or consolidation. The definition of *employer* in making this determination does not include employers required to be aggregated under the controlled group and affiliated service group rules.

Generally separation from service includes a distribution upon the employee’s:

1. Death,
2. Retirement, or
3. Resignation or discharge.

Caution: A recipient of a total distribution may satisfy the “severance from employment” definition, which will entitle them to receive their distribution, but unless the distribution is made on account of “separation from service,” it may not be eligible for favorable tax treatment, unless the age 59½, death, or disability requirement is satisfied.

²⁷ IRC Sections 414(b), (c), (m). See, too, 414(o).

Capital Gains Treatment

An individual may be eligible for the flat 20-percent capital gains tax if he or she was a participant in the plan making the distribution prior to 1974. Under certain circumstances, service from a predecessor plan may be included.²⁸ The portion of the distribution eligible for capital gains treatment are those amounts attributable to employer contributions made before January 1, 1974.

The capital gain portion of the distribution is computed by separating the distribution amount into two portions, namely, the ordinary income portion and the capital gains portion. The following calculations are used:

$$\text{Ordinary income} = \frac{\text{total taxable amount} \times \text{months of plan participation after 1973}}{\text{total months of plan participation}}$$

$$\text{Capital gains} = \frac{\text{total taxable amount} \times \text{months of plan participation before 1974}}{\text{total months of plan participation}}$$

For purposes of determining months of participation, any portion of a year before 1974 counts as 12 months, and any portion of a month after 1973 counts as a full month. Form 4972, which must be completed for 10-year averaging, contains an explanation of this calculation. See following example.

Ten-Year Forward Income Averaging

If a participant born before 1936²⁹ receives a lump-sum distribution and has been in the plan for five years preceding the year of the lump-sum distribution and is age 59½ or older, he or she may elect to use 10-year averaging on the distribution. Only one such election may be made after age 59½, and an election must apply to all lump-sum distributions received in the same year.

Under the 10-year forward income averaging rules, the amount is treated as if it were spread out over 10 years. The tax equals 10 times the tax on one-tenth of the total taxable amount reduced by the minimum distribution allowance.³⁰

²⁸ Ltr. Rul. 8004092 (Oct 31, 1979). When a partnership incorporated, the profit-sharing Keogh plan was discontinued and a pension plan was started. Ex-partners could aggregate their years of participation in the plans for purposes of ten-year averaging treatment.

²⁹ TRA 86 repealed the 10-year averaging method, however, for participants who attained age 50 before January 1, 1986, 10-year averaging may still be used. See IRC Section 402(e) prior to repeal.

³⁰ The 1986 tax rates are used. The tax is computed taking into account the prior law zero-bracket amount. The minimum distribution allowance is the *lesser of* (a) \$10,000, or (b) 50 percent of the total taxable amount. *The total taxable amount* is the employee's cost basis, reduced by distributions previously excludible from gross income. However, the allowance must be reduced by 20 percent of the total taxable amount in excess of \$20,000. Thus, if the total taxable amount is \$70,000 or more, the minimum exclusion allowance is zero.

Look-Back Rule

In applying the 10-year averaging rules, a special aggregation rule applies if the recipient has received more than one lump-sum distribution during the six taxable years ending with the close of the year of the current lump-sum distribution.

Generally, the rule requires that all lump-sum distributions received during this six-year period be aggregated for the purpose of determining the tax rate on the last lump-sum distribution. First, an aggregate tax is computed. The tax attributable to the prior lump-sum distributions is then subtracted to obtain the tax on the current lump-sum distribution.

Beneficiary(ies) Receiving Lump-Sum Distributions

A beneficiary who receives a lump-sum distribution may use capital gains treatment, or 10-year averaging under the same rules as the participant.³¹ The benefits under the participant's plan will generally be included in the participant's federal taxable estate, with the exception of amounts paid to the surviving spouse under the unlimited marital exclusion.

Distributions made before a total distribution (e.g., periodic payments made to an employee after retirement) will not preclude lump-sum treatment to a beneficiary after the participant dies. Lump-sum treatment may also be elected by a beneficiary of more than one qualifying decedent.

Lump-Sum Distributions to Multiple Recipients

If a lump-sum distribution from a qualified plan is divided between more than one recipient and when not all recipients are trusts, each individual, estate, or trust can separately elect capital gain treatment and 5- and 10-year averaging. In this case, a recipient figures the tax attributable to his or her percentage of the distribution in accordance with the instructions in Form 4972 for multiple recipients. A recipient can make the election even though the other recipients do not.

If Form 4972 is filed for a trust that shared the distribution only with other trusts, the tax is figured on the whole lump sum first. The trusts then share the tax in the same proportion that they shared the distribution.

Net Unrealized Appreciation in Employer Securities

If securities of the employer corporation are included in a lump-sum distribution, the net unrealized appreciation (NUA) in those securities is not subject to tax. The NUA is ordinarily excluded from any of the tax calculations that may apply to the lump-sum distribution. However, the recipient may elect to have the NUA included in gross income for the year of the distribution. The

³¹ The \$5,000 death benefit exclusion was eliminated for decedents dying after August 20, 1996.

election may be made simply by including the NUA on the return for the year of the distribution.

In general, NUA in employer securities is the difference between the fair market value (FMV) of the employer securities on the date of distribution and the cost or other basis of the stock. *Securities* includes the employer corporation's stock, bonds, registered debentures, and debentures with interest coupons attached. This term also includes securities of a parent or subsidiary corporation of the employer corporation.

In determining the total NUA, the cost basis is computed by the plan on a per share basis. In the case of a lump-sum distribution (without regard to the five-year participation requirement), all NUA in employer securities is excluded from the distributees' gross income until the employer securities are subsequently sold. In the case of a distribution which is not a lump-sum distribution, the portion of NUA in employer securities, which is attributable to employee contributions only, is excluded from the gross income of the distributee until those employer securities are subsequently sold.

The NUA (determined at the time of distribution) will be taxed at the long-term capital gains rate upon the subsequent sale, regardless of the length of time such securities were held by the employer's plan or the time held by the individual. However, any additional gains on the employer securities upon subsequent sale would be taxed at either the short- or long-term capital gains rate depending upon the actual holding period by the individual from the time the securities were distributed.

Although the plan's cost basis for purposes of determining the NUA may be composed of varying costs of shares purchased in different years, the shares distributed have a new basis which is the same for each share received in the distribution. This new basis would be used for purposes of determining gain or loss on a subsequent sale or other taxable disposition.³²

If an election is made to include NUA in current income, part of the NUA amount shown in Box 6 of Form 1099-R qualifies for capital gain treatment if there is an amount eligible for capital gain treatment shown in Box 3 of Form 1099-R. The 1099-R instructions include an NUA Worksheet for individuals who make the capital gain and NUA elections.

If a capital-gain election is not made but an election is made to include NUA in current income, the amount of the NUA shown in Box 6 of Form 1099-R is added to the amount from Box 2 of Form 1099-R, and the total amount is taxed as ordinary income under the 10-year averaging method.

Example. Paolo became an active participant in the Quark Corporation's pension plan on December 11, 1966, and continued to work until March 10, 1995, at which time he retired at age 62. He received a lump-sum distribution of \$205,000, consisting of \$40,000 in employer stock having a cost basis of \$20,000 and \$165,000 in cash. Paolo contributed \$10,000 as nondeductible voluntary contributions to the plan during his years of service.

³² Rev. Rul. 57-114.

In determining active participation for purposes of the allocation to capital gain, Paolo has 96 months (12 x 8 – 1966 counts as 12 months) of participation before 1974 and 243 months (240 + 3 – March 1995 counts as a full month) of participation after 1973.

Paolo's taxable distribution is \$175,000 calculated as follows:

Total Distribution	\$205,000
Less: Employee Contributions	\$ 10,000
Less: NUA	\$ 20,000
Total Taxable Amount	\$175,000

Of this total taxable amount, the portion allocated to capital gain is computed as follows:

$$\frac{\$175,000 \times 96 \text{ (pre-1974 months)}}{339 \text{ (total months)}} = \$49,558$$

The allocation to ordinary income would be as follows:

$$\frac{\$175,000 \times 243 \text{ (post-1973 months)}}{339 \text{ (total months)}} = \$125,442$$

Since Paolo was age 53 on January 1, 1986 (born before 1936), he is eligible to elect 10-year averaging for the ordinary income from the lump-sum distribution. If he elects 10-year averaging, the separate tax on the ordinary income would be:

$$\text{The tax on } \$12,544.20 \text{ (1/10 of } \$125,442) = \$1,927.14$$

$$\$1,927.14 \times 10 = \$19,271.40$$

$$\text{Separate tax on ordinary income} = \$19,271.40$$

$$\text{Tax on capital gain portion (20\%} \times \$49,558) = \$9,911.60$$

$$\text{The total tax is } \$29,183.00 \text{ } (\$19,271.40 + \$9,911.60)$$

Preretirement Distributions

In general, for distributions made after July 1, 1986, the basis recovery rules depend on the timing of the distributions. There are different rules depending on whether the participant begins distributions before the *annuity starting date* or after such date.

Distributions received before the annuity starting date (preretirement distributions) made to an employee who has a cost basis under a pension, profit-

sharing, or stock bonus plan, or under an annuity contract purchased by any such plan, are taxed as ordinary income under a rule that provides for pro-rata recovery of cost.³³ The employee excludes the portion of the distribution that bears the same ratio to the total distribution as his investment in the contract bears to the total value of the employee's accrued benefit on the date of the distribution. Generally, the total value of an employee's account balance is the FMV of the total assets under the account, excluding any net unrealized appreciation attributable to employee contributions (whether or not all such securities are distributed). The premature distribution penalty tax may apply if an amount is received before age 59½, unless another exception applies.

The *annuity starting date* is the first day of the first period for which an amount is received as an annuity under the plan or contract.³⁴

Grandfather Rule

If a plan permitted in-service withdrawal of employee contributions on May 5, 1986, the pro-rata recovery rules do not apply to investment in the contract prior to 1987. Instead, the pre-1987 investment in the contract will be recovered first, and the pro-rata recovery rules will apply only to the extent that amounts received before the annuity starting date (when added to all other amounts previously received under the contract after 1986) exceed the employee's investment in the contract as of December 31, 1986.³⁵

If employee contributions are transferred after May 5, 1986, from a plan that permitted in-service withdrawals to another plan permitting such withdrawals, the pre-1987 investment in the contract under both plans continues to qualify for grandfather treatment. If the transferor plan did not permit such in-service withdrawals, only the pre-1987 investment in the contract under the transferee plan qualifies.³⁶

Even if an employee cashed out prior to 1986 and buys back after 1986, he or she cannot use the grandfather rule, because there is no pre-1987 investment in the contract. But, if the cash-out occurs after 1986, and there was investment in the contract as of December 31, 1986, the cashout causes a permanent reduction in the grandfathered investment, which may not be restored by a later buyback.³⁷

Distribution of Annuity or Life Insurance Contract

If an annuity contract is distributed, the employee will not be taxed on its value unless and until he or she surrenders the contract. The employee will be taxed on the annuity payments as they are received. A contract issued after 1962, however, must be nontransferable in order to qualify for this tax-

³³ IRC Sections 402(a); 72(e)(8).

³⁴ IRC Section 72(c)(4).

³⁵ IRC Section 72(e)(8)(D); Ltr. Rul. 9652031.

³⁶ Notice 87-13 (1987-1 CB 432); Ltr. Rul. 8829017, 8829006.

³⁷ Notice 89-25, A-5 (1997-1 CB 662).

deferred treatment.³⁸ However, the transfer of an annuity to a divorced spouse pursuant to a divorce decree will not violate the nontransferability requirement.³⁹ A IRC Section 1035 exchange to a similar contract meeting the nontransferability restrictions and other applicable requirements does not necessarily violate the nontransferability.⁴⁰

If the employee surrenders the annuity contract after the year of distribution, the gain realized on surrender is taxable as ordinary income and will not qualify for taxation as a lump-sum distribution.⁴¹ However, the unsundered annuity contract will affect the taxation of any lump-sum distribution of which it is a part or which is made in the same year. If the annuity is surrendered in the year of distribution, the proceeds will either be taxed as ordinary income, or, if the distribution of the annuity is part or all of a lump-sum distribution, under the lump-sum distribution rules. If the annuity is distributed in an eligible rollover distribution, tax may be deferred by rolling the amount over to IRA or other plan that accepts rollovers (and in accordance with the rules under such plan). The employee's cost basis is deducted first from the cash and property other than the annuity. Any excess is used to reduce the value of the annuity.⁴²

Life Insurance Contract

If a retirement income or endowment contract, or life insurance policy is distributed, its cash value is immediately taxable to the employee to the extent that it exceeds the employee's basis unless:

- The contract is converted to an annuity (with no life insurance element) no later than 60 days after it is distributed; or
- The contract (or its proceeds if a life insurance contract) are rolled over⁴³

The contract itself may not be rolled over to an IRA.⁴⁴ If the policy is distributed in a lump-sum distribution, the taxable amount is eligible for favorable capital gains and special averaging treatment to the extent that such rules are still applicable.

If death occurs after the policy has been distributed from the plan, the beneficiary is not subject to tax on the policy proceeds.⁴⁵

³⁸ IRC Section 401(g); Treas. Regs. Sections 1.402(a)-1(a)(2), 1.401-9.

³⁹ Ltr. Rul. 8513065.

⁴⁰ See, Ltr. Rul. 9241007, 9233054; GCM 39882 (10-30-92).

⁴¹ Rev. Rul. 81-107, 1981-1 CB 201.

⁴² Prop. Treas. Reg. Section 1.402(e)-2(c)(1)(ii)(C).

⁴³ Treas. Regs. Sections 1.402(a)-1(a)(2), 1.401-9; Rev. Rul. 60-84, 1960-1 CB 159. However, in a springing cash value policy (where the FMV of the policy is substantially higher than its cash value), then the total reserves are used, not the cash value. See Notice 89-25, 1989-1 CB 662, A-10.

⁴⁴ IRC Section 408(a)(3).

⁴⁵ IRC Section 101(a); Rev. Rul. 63-76, 1963-1 CB 23.

Disability Benefits

The tax treatment of disability payments from a qualified plan depends upon whether the payments are made to a common-law employee or a self-employed individual:

- *Payments to a common law employee.* If the disability pension is derived from employer contributions and is made in lieu of wages to an employee who retired on account of permanent and total disability, the employee may be entitled to a tax credit.⁴⁶ A common-law employee is not entitled to exclude from income any part of a disability benefit derived from employer contributions.⁴⁷
- *Payments to self-employed individuals.* If a self-employed individual receives distributions from a plan because he or she became permanently disabled, the disability payments are taxed under the same rules that apply to retirement benefits. But if the self-employed individual receives the disability payments through health insurance, he may exclude from his gross income any amounts attributable to non-deductible contributions as a self-employed person.⁴⁸

Death Benefits

If an employee dies before retirement and the death benefit is payable from the proceeds of a life insurance policy, the difference between the cash surrender value and the face amount is treated as the death proceeds of life insurance, and is excluded from income,⁴⁹ but only if the insurance cost (under Table 2001 or the P.S. 58 rates⁵⁰) has been paid with nondeductible employee contributions or has been taxable to the employee.⁵¹ The balance of the proceeds (representing the cash surrender value) is treated as a distribution from the plan.⁵²

Failure to Withdraw a Required Minimum Distribution

If the amount distributed during a tax year is less than the amount required to be distributed under the RMD rules for the year, there is generally a tax

⁴⁶ IRC Section 22(a).

⁴⁷ Social Security Amendments Act of 1993, Section 122(b).

⁴⁸ IRC Sections 104(a)(3), 105(g); Treas. Reg. Section 1.105-1(a), (b); See, too, Treas. Reg. Section 1.72-15(g).

⁴⁹ IRC Section 101(a).

⁵⁰ The table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, is more commonly referred to as the "P.S. 58" rates. Notice 2001-10 set forth a new table of one-year term premiums, Table 2001, to determine the value of current life insurance protection on a single life provided under a split-dollar life insurance arrangement for taxable years ending after January 29, 2001. Under Notice 2001-10, Table 2001 is to serve as a substitute for the outdated P.S. 58 rates.

⁵¹ Treas. Reg. Section 1.72-16(c)(4).

⁵² IRC Section 72(m)(3)(C); Treas. Reg. Section 1.72-16(c).

equal to 50 percent of the amount that the distribution made in the year falls short of the required amount. The tax is on the payee.⁵³

Premature Distribution Penalty Tax

Amounts distributed prior to age 59½ from a qualified plan, SEP, SIMPLE IRA, or 403(b) arrangement may be subject to a nondeductible excise tax of 10 percent. The penalty may also apply to assets that were subject to the restriction and which were transferred into and later distributed from an eligible governmental 457 plan. If the penalty tax on early distributions from a SIMPLE IRA applies to a distribution within the two-year period, the tax increases from 10 percent to 25 percent.⁵⁴

There are a number of exceptions to the early distribution penalty tax if the individual is under age 59½. As noted, some of the exceptions only apply to qualified plans, some only to IRAs, and some to employees that have separated from service. If over age 59½, one of the other exceptions may apply, and the exceptions are as follows:

1. *Death.* The early distribution is made to a beneficiary (or to the estate of the employee or IRA owner) upon or after the death of the employee or IRA owner.
2. *Disability.* The distribution is attributable to the employee's or IRA owner's being disabled within the meaning of IRC Section 72(m)(7).

An individual is considered to be disabled if he or she is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." Proof of the existence of such disability must be provided. (See IRC Section 72(m)(7); Treas. Reg. Section 1.72-17A(f).)

In a recent Tax Court case involving the definition of disability under IRC Section 72(m), the court found that a particular taxpayer's continuing depression qualified for the standard for the disability exception and was not liable for the 10-percent early distribution penalty.⁵⁵

3. *Substantially equal periodic payments.* The early distribution is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or IRA owner or the joint lives (or joint life expectancies) of the employee or IRA owner and his or her designated beneficiary. Under

⁵³ IRC Section 4974.

⁵⁴ IRC Section 72(t)(6).

⁵⁵ See, *Coleman-Stephens v. Comm'r*, T.C. Summ. Op. 2003-91 (2003). The case was heard pursuant to the provisions of IRC Section 7463 regarding judicial proceeding involving disputes of less than \$50,000. Although such decisions are not reviewable by any other court and the opinion should not be cited as authority, it is nevertheless instructive of the IRS's view of the disability exception and the court's analysis of the IRS's position. For a copy, see <http://www.ustaxcourt.gov/InOpHistoric/Coleman-Stephens.SUM.WPD.pdf>.

this exception, distributions from IRC Section 401(a) qualified plans must begin after separation from service.⁵⁶

4. *Qualified higher education expenses.* An IRA distribution is used to pay qualified higher education expenses (including graduate education) for the employee, the employee's spouse, or any child or grandchild of either.
5. *First-time homebuyer expenses.* An IRA distribution for first-time homebuyer expenses is limited to a lifetime maximum of \$10,000. The distribution must be used within 120 days to buy, build, or rebuild the principal residence of the individual, his or her spouse, or any child, grandchild, or ancestor of either. A person qualifies as a first-time homebuyer if he or she (and his or her spouse) has had no ownership interest in a principal residence during the preceding two years.
6. *Unreimbursed medical expenses.* The distribution does not exceed the amount allowable as a deduction under IRC Section 213 relating to amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).
7. *Medical insurance for unemployed individuals.* To the extent of medical insurance paid during the year for an individual, an individual's spouse or dependents, provided all five of the following conditions apply:
 - a. The distribution is made from an IRA.
 - b. The individual lost his or her job.
 - c. The individual received unemployment compensation paid under any federal or state law for at least 12 consecutive weeks.
 - d. The distribution is received either during the year the unemployment compensation was received or the following year.
 - e. The distribution is received no later than 60 days after the individual has been reemployed.
8. *IRS levy.* The early distribution is made on account of a levy under IRC Section 6331.

Note. The IRS can enforce a federal lien against an IRA.⁵⁷ Amounts distributed from an IRA, even if used to satisfy a federal lien, are generally (but not always) subject to the premature distribution penalty if the IRA owner is under age 59½. (See Chief Counsel Notice N(36)000-2 (Jan 21, 2000).)

9. *Divorce or separation.*
 - a. *IRA, Roth IRA, or SIMPLE IRA.* Amounts directly transferred to an IRA, Roth IRA, or the SIMPLE IRA of a spouse (or former spouse) under a divorce or separation instrument under IRC Sec-

⁵⁶ IRC Section 72(t)(3)(B).

⁵⁷ IRC Section 6334.

tion 408(d)(6) are not subject to penalty tax because they are not taxable nor are they deemed taxable for this purpose.⁵⁸ The amounts are or simply become the IRA or SIMPLE IRA of the spouse (or former spouse). Assets that are rolled over to the spouse's IRA (other than by direct transfer) do not qualify under this exception, and are taxable to the initial recipient.

- b. Qualified plans and annuities.* Plans qualified under IRC Sections 401(a) and qualified annuity plans under IRC Section 403(a) are subject to the QDRO rules requiring payments to an alternate payee (generally, the former spouse) that are made pursuant to a state domestic relations law (including community property law).⁵⁹ Payments under a QDRO or domestic relations order (DRO) are not subject to the premature distribution penalty tax.
- 10. *Separation after age 55.* Distributions from a qualified plan or qualified annuity plan after attainment of age 55 after separation from service. The age requirement must be satisfied before the separation from service occurs to qualify under this exception.
- 11. *ESOP dividends.* Distributions with respect to a qualified ESOP of dividends on employer securities.⁶⁰

⁵⁸ IRC Sections 72(t)(1), 408(d)(6).

⁵⁹ IRC Section 414(p)(1).

⁶⁰ IRC Sections 72(t)(2)(A)(vi), 404(k).

Chapter 15

Rollovers and Portability

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Rollovers and Portability

With certain restrictions and depending upon the plan design, many plan distributions are portable to other types of plans. This chapter discusses rollovers from employer-sponsored plans to individual retirement accounts or annuities (IRAs), as well as rollovers between employer-sponsored plans. Distribution restrictions and the timing of subsequent distributions of rolled over and directly transferred amounts are included in this chapter. Withholding rules on distributions, exceptions, and other related issues are also included. Summary charts of rollovers from and between IRA-based plans and employer plans charts are provided at the end of this chapter.

General Rollover and Direct Rollover Rules

Employer Plans Eligible for Rollover to a Traditional IRA

All eligible rollover distributions¹ from any qualified employer-sponsored plan, 403(b), thrift savings plan or an Internal Revenue Code (IRC) Section 457(b) governmental plan (457(b) plan) must be reported to the Internal Revenue Service (IRS) by the distributing plan on IRS Form 1099-R,² the receiving traditional IRA plan on Form 5498,³ and on the taxpayer's income tax return, even where the amount is paid as a *direct rollover*.

The following employer plans are eligible to be rolled over to a traditional IRA:

- *Plan Qualified Under Internal Revenue Code (IRC or the Code) Section 401(a) or 403(a).*⁴ A qualified plan can be categorized as either a defined-benefit plan or defined-contribution plan. Defined-contribution

¹ Defined in IRC Section 402(c)(4).

² Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

³ Form 5498, IRA Contribution Information.

⁴ IRC Section 402(c)(8)(B).

plans include money-purchase pension, profit-sharing, 401(k), and stock bonus plans.⁵

- *Simplified Employee Pension Plan (SEP)*. Although a SEP is considered to be an employer-sponsored plan, SEP contributions are made to the employee's IRA. Therefore, the IRA-to-IRA rollover rules apply.⁶
- *Savings Incentive Match Plan for Employees (SIMPLE)*. SIMPLE retirement plans are also considered to be employer-sponsored plans where, in the IRA form, the contributions are made into the employee's SIMPLE IRA. Even though the IRA-to-IRA rollover rules apply to transactions made between SIMPLE IRAs, these SIMPLE IRA assets will not be allowed to be rolled to any other type of IRA until the initial two-year holding period has expired. A SIMPLE IRA distribution may be rolled over or directly transferred within the two-year period only to another SIMPLE IRA. The two-year period begins on the first-day contributions are deposited by the employer into the SIMPLE IRA account of the employee.⁷
- *Employer Group IRA*.⁸ Since employer IRA contributions are made into the employee's IRA, the IRA-to-IRA rollover rules apply.⁹
- *Tax-Sheltered Annuity or Custodial Account Under IRC C Section 403(b)*.¹⁰ An IRC Section 403(b) may be established by an educational institution, certain ministers, and other tax-exempt organizations that are exempt from tax under IRC Section 501(c)(3).¹¹
- *Federal Employee's Thrift Savings Plan*. The federal employee's Thrift Savings Plan (TSP) is a type of retirement plan established under the Federal Employees' Retirement Systems Act of 1986.¹² Under this unique governmental plan, an employee who separates from service must be provided the option of having amounts transferred directly from the TSP to the individual's IRA in the form of a direct rollover. The TSP will produce a Form 1099-R for the amount of the direct rollover and the accepting IRA trustee or custodian must report the direct rollover as a rollover contribution on a Form 5498.
- *Governmental 457(b) Plan*.¹³ Beginning with eligible rollover distributions after December 31, 2001, the amount is eligible to be rolled over to an IRA under the same conditions as rollovers from qualified plans. If a former employee has already begun a series of distributions from

⁵ IRC Sections 402(c), 403(a)(4).

⁶ IRC Section 408(d)(3).

⁷ IRC Section 408(d)(3)(G).

⁸ IRC Section 408(c).

⁹ IRC Section 408(d)(3)(A).

¹⁰ IRC Section 403(b)(8).

¹¹ IRC Section 403(b)(1)(A).

¹² Title 5 U.S.C. Section 8433(b)(4), (c)(4), (d).

¹³ IRC Section 457(e)(16).

the 457(b) plan under an irrevocable election prior to 2002, the payments being made thereafter are probably not eligible for rollover.¹⁴

There are no provisions under the IRC to allow for a qualified plan, 403(b) plan, or eligible governmental 457(b) plan to roll over directly to a Roth IRA.¹⁵ Therefore, an employee must first roll the employer plan assets to a traditional IRA and then complete a conversion from the traditional IRA to the Roth IRA.¹⁶

Plans Not Eligible for Rollover to Traditional IRAs

Distributions and payments from the following plan types may *not* be rolled over to a traditional IRA:

- A deferred compensation plan of a tax-exempt organization under IRC Section 457 (eligible 457 plan) other than an eligible governmental plan of a state or local government
- A governmental plan other than a qualified plan, governmental 457(b), or the federal employee's TSP
- A Roth IRA
- Coverdell Education Savings Account (ESA or Ed IRA)
- Foreign Country Retirement Plan¹⁷

Conditions for Rolling Over to Another Employer Plan

In order for an employer plan to be rolled over to another employer plan, the recipient plan must specifically accept the rollover contribution. Rolling over between “like” plans is generally permitted. For example, qualified plan to qualified plan, 403(b) to 403(b), and so on, so long as the receiving plan accepts rollovers. Employers are not required to have their plans accept a rollover from other plans. If a plan accepts rollovers from other plans, the receiving plan may restrict subsequent distributions of the rollover amount and must require spousal consent for any subsequent distribution when applicable. Moreover, a subsequent distribution from the plan that accepts rollovers may be subject to different tax treatment than distributions from the receiving plan. For example, the 10-percent premature distribution penalty tax may apply to distributions from the receiving plan that would not have applied to distributions from the transferring plan.

An employer that chooses to allow rollovers must specifically list the types of plans that the receiving plan will accept in the form of a rollover contribu-

¹⁴ IRC Section 457(e)(16).

¹⁵ IRC Section 408A(c)(3)(B) only allows rollovers from traditional IRAs (including a SEP-IRA) to be made to a Roth IRA.

¹⁶ IRC Section 408A(d)(3). Under TRA 97, an individual may convert traditional IRA assets to a Roth IRA.

¹⁷ In Ltr. Rul. 9833020, a U.S. citizen and resident worked in Canada. The taxpayer was prohibited from rolling a foreign country's retirement savings plan into either a U.S. traditional IRA or other U.S. retirement plan. It was neither a qualified plan nor an IRA. Treaties are discussed.

tion. The receiving plan is also required to separately account for the rollover amounts.¹⁸

Example. Abigail has a conduit IRA solely consisting of assets that were recently rolled over from her previous employer's qualified plan. That plan provided for direct transfers, but Abigail choose to accept cash instead, and rolled over the taxable amount to her conduit IRA. Abigail's new employer, Feline Care, maintains a qualified plan with no age or service requirements that permits participants to rollover amounts from "plans qualified under IRC Section 401(a) and eligible governmental 457 plans." Abigail's conduit IRA is not permitted to be rolled over into Feline's qualified plan because it is not specifically mentioned in the plan document, although it could have been rolled over by direct transfer to Feline's plan had Abigail not chosen to receive a taxable distribution.

Maximum Amount Eligible for a Rollover or Direct Rollover

For eligible rollover distributions prior to January 1, 2002, only the taxable portion of the distribution was eligible to be rolled over to a traditional IRA or another employer's plan that accepted such rollovers. However, beginning with eligible rollover distributions after December 31, 2001, eligible rollover distributions can contain the employee's after-tax contributions.¹⁹

Rollovers of After-Tax Employee Contributions

If after-tax contributions are rolled over from one qualified plan to another qualified plan (or from one 403(b) to another 403(b)), the receiving plan must keep separate accounting records of the rollover contribution, including separate accounting for the after-tax employee contributions and earnings on those contributions.

After-tax contributions can be rolled over to a traditional IRA, either as a 60-day rollover or as a direct rollover. The taxpayer is required to keep track of and report to the IRS on applicable forms, the amount of these after-tax contributions. The financial institution accepting the rollover to the traditional IRA is not responsible to keep separate records on the person's after-tax employee contributions.²⁰

Qualified Plans

After-tax employee contributions made to a qualified plan may only be rolled over to another qualified plan that accepts these rollovers. Such rollovers must be in the form of a direct rollover. No 60-day rollover is permitted of after-tax contributions, except to a traditional IRA.

¹⁸ IRC Section 408(c)(10).

¹⁹ IRC Section 402(c)(2).

²⁰ IRC Section 402(f) Notice, Section 1.

After-tax employee contributions made to a qualified plan cannot be rolled over to a 403(b) or 457(b), but could be rolled over as a direct rollover or as a 60-day rollover into a traditional IRA.

403(b) Plans

Similarly, after-tax employee contributions made to a 403(b) plan may only be rolled over to another 403(b) plan that accepts such rollovers. The rollovers must be in the form of a direct rollover. No 60-day rollover is permitted of after-tax contributions, except to a traditional IRA. After-tax employee contributions made to a 403(b) cannot be rolled over to a qualified plan or 457(b) plan, but could be rolled over as a direct rollover or as a 60-day rollover into a traditional IRA.

Eligible Rollover Distributions

Assuming the plan permits the distribution, eligible rollover distribution²¹ is *any* distribution except the following:

1. Part of a series of substantially equal payments over a period of 10 years or longer
2. Part of a series of substantially equal payments made over the participant's life or life expectancy, or over the joint lives or joint life expectancies of the participant and the designated beneficiary
3. Attributable to the participant's required minimum distribution for the year
4. Any distribution which is made upon hardship of the employee, or in the case of a 457(b) plan, any distribution on account of an unforeseeable emergency
5. Death distribution made to nonspouse beneficiaries or qualified domestic relations order (QDRO) paid to a nonspouse alternate payee

Additional exceptions found in the IRS regulations include:

1. The return of an excess contribution, excess deferral, and excess aggregate contributions, together with the income allocable to these corrective distributions, under a 401(k) plan
2. The return of an elective deferral with income allocable under a 401(k) plan that is returned as a result of the IRC Section 415 limitations violation²²
3. Deemed distributions of the cost of life insurance coverage
4. Deemed distributions upon the default of a participant loan
5. Dividends paid on employer securities in an employee stock ownership plan (ESOP)²³

²¹ IRC Section 402(c)(4); Treas. Reg. Section 1.402(c)-2, Q&A 3.

²² Treas. Reg. Section 1.415-6(b)(6)(iv).

²³ As described in IRC Section 404(k).

Practice Pointer: An eligible rollover distribution includes net unrealized appreciation in employer securities and loan offset amounts, discussed later. Distributions that are not eligible rollover distributions are exempt from the 20-percent mandatory income tax withholding requirements, but are subject to the voluntary withholding rules, unless there is an exception.

Distribution Timing of Amounts Rolled Over to Employer Plan

If an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, distributions of those amounts are not subject to the restrictions on permissible timing that apply to distributions of other amounts from the plan.²⁴ Thus, a plan may permit the distribution of amounts attributable to rollover contributions at any time pursuant to an individual's request. However, other requirements applicable to the receiving plan may apply.

Example. A qualified money-purchase pension plan separately accounts for amounts attributable to rollover contributions. A plan provision permitting the in-service distribution of those amounts will not cause the plan to satisfy the requirements that distributions be made after retirement.

Similarly, if the receiving plan is an eligible governmental 457(b) plan or a 403(b) tax-sheltered annuity or custodial account, amounts attributable to rollovers that are maintained in separate accounts are permitted to be distributed at any time even though distribution of other amounts under the plan or contract cannot be made until a later time.²⁵

Survivor Annuity Requirements

A distribution of an amount attributable to a rollover contribution is subject to the survivor annuity requirements as applicable to the receiving plan.²⁶

Minimum Distribution Requirements

A distribution of an amount attributable to a rollover contribution is subject to the minimum distribution requirements as applicable to the receiving plan.²⁷

Exceptions From Premature Distribution Penalty

A distribution of an amount attributable to a rollover contribution is subject to the premature distributions provisions applicable to the receiving plan.²⁸

Example. Lisa, age 56, properly rolls over a distribution from an IRA into her employer's qualified money-purchase pension plan that separately accounts for amounts attributable to rollover contributions. The following year,

²⁴ Rev. Rul. 2004-12 (2004-__ IRB __); IRC Sections 401(a)(31), 402(c), 402(c)(2), 403(a)(5), 403(b)(10), 457(d)(1)(C).

²⁵ IRC Sections 403(b)(7), 403(b)(11), 457(d)(1)(A).

²⁶ IRC Sections 401(a)(11), 417.

²⁷ IRC Section 401(a)(9).

²⁸ IRC Section 72(t).

she separates from service. Her distribution is not subject to the 10-percent premature distribution penalty tax because it was distributed from a qualified plan after she attained age 55. Had it been removed from an IRA, the exception (separation after age 55) would not have applied.

Although some of the IRC Section 72(t) exceptions only apply to IRAs, others only apply to qualified plans. (See Chapter 25, “Nonqualified Deferred Compensation.”) In the case of eligible governmental 457(b) plans, which are not generally subject to the premature distribution penalties, amounts rolled over are subject to the premature distribution penalties applicable to distributions from a qualified plan.²⁹

Merger, Consolidation, and Transfers

Restrictions on the timing of permitted distributions continue to apply in non-rollover situations, such as amounts received by a plan as a result of a merger, consolidation or transfer of plan assets under IRC Section 414(l), or to plan-to-plan transfers otherwise permitted between 403(b) tax-sheltered annuities custodial accounts, and between eligible governmental 457(b) plans.³⁰

Substantially Equal Payments Not Eligible for Rollover

Change in Amount of Payments or the Distributee³¹

If the amount of the payments changes so that subsequent payments are not substantially equal to prior payments, a new determination must be made as to whether the remaining payments are a series of substantially equal periodic payments. This determination is made without taking into account payments made prior to the change. However, a new determination is not made merely because the spouse becomes the distributee upon the death of the employee.

Series of Payments Beginning Before 1993

If a series of periodic payments began before 1993, the determination of whether the post-1992 payments are eligible rollover distributions is made by taking into account all payments made, including payments made before 1993.³²

Example. Holly began payments over 15 years from her employer’s qualified plan in 1983. Although payments made after December 31, 1992, will continue for only five more years, her pre-1993 payments are included in determining the specified period. In this case, her entire series is 15 years, which makes her post-1992 payments ineligible for rollover distribution treatment.

²⁹ IRC Section 72(t)(9).

³⁰ See Rev. Ruls. 2004-12 (2004-1 C.B. __), 69-277 (1969-1 C.B. 116), 90-24 (1990-1 C.B. 97), 94-76 (1994-2 C.B. 46).

³¹ Treas. Reg. Section 1.402(c)-2, Q&A 5(c).

³² Treas. Reg. Section 1.402(c)-2, Q&A 5(e).

Random or Independent Payments

A payment is treated as independent of other payments in a series if the payment is substantially larger or smaller than the other payments in the series. As a result, such independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of an eligible rollover distribution. This is the case regardless of whether the independent payment is made before, with, or after payments in the series.³³

Example. Heather begins life expectancy payments in 1990 over a 20-year period. In 1993, she decides to close her account and take the entire remaining balance. The 1993 distribution would be considered an eligible rollover distribution since it would be an independent payment larger than the other payments in the series.

Example. Morgan elects a single payment of half of her account balance with the remainder of the account balance paid over Morgan's life expectancy. The single payment is treated as independent of the other payments in the series, and is an eligible rollover distribution.

Substantially Equal Payments From a Defined-Contribution Plan

In determining whether a series of payments from a defined-contribution plan constitutes substantially equal periodic payments, the following rules apply:³⁴

- *Declining years.* A series of payments from an account balance under a defined-contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments to be made over 10 years is determined as follows: In the first year, the annual payment is the account balance divided by 10; in the second year, the annual payment is the remaining account balance divided by 9; and so on until year the tenth year, when the entire remaining balance is distributed.
- *Reasonable actuarial assumptions for fixed payment amounts.* In situations in which a participant receives a fixed payment on a monthly, quarterly, or annual period, reasonable actuarial assumptions must be used to determine the period of years over which the payments will be made. For example, a participant with \$100,000 in plan assets requests a \$1,000 distribution per month until the account is exhausted. The plan administrator assumes a reasonable rate of interest to be 8 percent per year. Therefore, the account balance will be exhausted in approximately 14 years. Since this period of distribution exceeds 10 years, the \$1,000 per month would not be eligible for roll-

³³ Treas. Reg. Section 1.402(c)-2, Q&A 6.

³⁴ Treas. Reg. Section 1.402(c)-2 Q&A 5(d).

over purposes and, therefore, would not be subject to the 20-percent mandatory withholding.

10-Percent Additional Tax

Although a plan permits a distribution, if the participant does not roll over or elect a direct rollover to another plan, the distribution might be subject to the 10-percent additional income tax if the recipient is under the age of 59½, unless an exception applies.

Distributions From a 457(b) Plan

Distributions from a 457(b) plan are not generally subject to the 10-percent additional tax on premature distributions. However, any distribution from a 457(b) that is attributable to any amount rolled over to the 457(b) (adjusted for investment returns) from another type of plan or IRA is subject to the 10-percent additional tax, unless such distribution meets an exception to the 10-percent penalty.

Distributions From Other Plan Types or an IRA

Unless an exception applies, distributions from any employer plan (other than a 457(b) plan) or IRA are subject to a 10-percent additional income tax. Also, any amount rolled over from a 457(b) plan to another type of plan or traditional IRA will be subject to the additional 10-percent tax if it is distributed from the other plan unless an exception applies. In other words, if a 457(b) plan is rolled over to another type of plan, it takes on the characteristics of the receiving plan when subsequent distributions are made.

Direct Rollover Election Requirement

A plan participant must be given the option to elect to have his or her eligible rollover distribution made in a direct rollover payment to the trustee or custodian of an eligible retirement plan. For purposes of this rule, an eligible retirement plan includes a traditional IRA, IRA annuity, or another employer's plan, which accepts such rollover contributions.³⁵ If an employer fails to permit such an election to his or her employees, the employer's entire plan runs the risk of being disqualified.³⁶

A qualified plan is required to offer a direct rollover to any defined-contribution plan that accepts rollovers, and is *permitted* (but not required) to offer a direct rollover to a defined-benefit plan that accepts rollovers.³⁷ An eligible rollover distribution that is paid in a direct rollover to a defined-benefit plan is not subject to the mandatory 20-percent withholding.³⁸

³⁵ IRC Sections 401(a)(31)(D), 402(c)(8)(B); Treas Reg. Section 1.401(a)(31)-1, Q&A 2.

³⁶ Treas. Reg. Section 1.401(a)(31)-1, Q&A-1.

³⁷ Treas. Reg. Section 1.401(a)(31)-1, Q&A-2.

³⁸ Treas. Reg. Section 1.401(a)(31)-1, Q&A-5.

Irrevocable Rollover Designation

The trustee or custodian of an IRA plan must obtain the written designation of an IRA holder that he or she is irrevocably electing to treat the contribution as a rollover contribution. An election is made by designating to the trustee or issuer of the IRA that the contribution is a rollover contribution. This election is irrevocable. Once any portion of an eligible rollover distribution has been contributed to an IRA and designated as a rollover contribution, taxation of any subsequent distributions from the IRA will be determined under the IRA rules. Thus, any such distributions from the IRA will not be eligible for any favorable tax treatment even though the original qualified plan distribution was eligible for special tax treatment. If an eligible rollover distribution is paid to an IRA in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution.³⁹

Withholding Requirements

Mandatory 20-Percent Withholding Requirement

If a participant does not elect to have the eligible rollover distribution from a qualified plan, 403(b) plan, 457(b) plan, or a TSP paid in a direct rollover to another plan, the employer or payor is required to withhold federal income tax at a rate of 20 percent.⁴⁰ The participant may not waive withholding.⁴¹

Example. Sherwood Jones is expected to receive a distribution from his employer's plan in the amount of \$200,000. This entire amount is fully taxable upon distribution and qualifies as an eligible rollover distribution. Sherwood does not elect to have this amount paid as a direct rollover to another plan. Sherwood's employer must withhold and remit 20 percent of the distribution to the Department of the Treasury system. Sherwood will receive Form 1099-R at the end of the year reporting that \$200,000 is the taxable amount of the distribution and that \$40,000 was withheld for federal income tax. Because the distribution is eligible to be rolled over to another plan within 60 days, Sherwood would need to add an additional \$40,000 from other sources if he wants to roll over the entire taxable amount. If Sherwood rolls over only the \$160,000 which he received from his employer, Sherwood would be required to include \$40,000 into income, subject to normal income taxes and 10-percent additional income tax if Sherwood is not yet age 59½, unless another exception applied. Either way, Sherwood still reports the \$40,000 withheld on his federal income tax return as a tax payment.

³⁹ Treas. Reg. Section 1.402(a)(5)-1T and 1.402(c)-2, Q&A 13.

⁴⁰ IRC Section 3405(c); Treas. Reg. Section 31.3405(c)-1.

⁴¹ Treas. Reg. Section 31.3405(c)-1, Q&A 2.

Additional Withholding by Agreement

A distributee and plan administrator or payor are permitted to enter into an agreement to provide for withholding in excess of 20 percent from an eligible rollover distribution. Such an agreement is effective for such period as the parties mutually agree. Either party may also terminate the agreement by furnishing a signed written notice to the other party.⁴²

Withholding on Split Distributions

If an employee elects to have a portion of an eligible rollover distribution paid as a direct rollover to another plan and to receive the remainder of the distribution, mandatory withholding (20 percent) applies only to the portion of the distribution received by the individual and not to the portion paid as a direct rollover.⁴³

Property Distributions and Mandatory Withholding

If all or a portion of an eligible rollover distribution consists of property other than cash and is subject to the 20-percent withholding requirement, the employer must sell the property (except employer securities) in amounts sufficient to pay the withholding.⁴⁴ No withholding is required if the eligible rollover distribution consists solely of employer securities and cash less than \$200.⁴⁵

Net Unrealized Appreciation in Employer Securities

An eligible rollover distribution can include net unrealized appreciation (NUA) from employer securities, even if the NUA portion is excluded from gross income. To the extent that the NUA portion of an eligible rollover distribution is excludible from gross income, the NUA portion is not a “designated distribution” subject to withholding because it is reasonable to believe that it is not includible in gross income.⁴⁶ To the extent that the NUA portion is excludible from gross income, the NUA portion is not included in the amount of an eligible rollover distribution that is subject to mandatory withholding. If the distribution consists solely of employer securities, no withholding is required.

Withholding on Distributions Not Eligible for Rollover

If the distribution does not qualify as an “eligible rollover distribution,” then withholding is based upon the voluntary withholding rules, including the employee’s ability to waive the withholding requirement.⁴⁷ The amounts to be

⁴² Treas. Reg. Section 31.3405(c)-1, Q&A 3.

⁴³ Treas. Reg. Section 31.3405(c)-1, Q&A 6.

⁴⁴ Treas. Reg. Section 31.3405(c)-1, Q&A 9, 10(d) and 11.

⁴⁵ Treas. Reg. Section 31.3405(c)-1, Q&A 14.

⁴⁶ Treas. Reg. Sections 1.402(c)-2 Q&A 3(b)(3), 31.3405(c)-1, Q&A-12; IRS Notice 93-3, Section V.

⁴⁷ IRC Section 3405(a) and (b).

withheld under the voluntary withholding rules differ, depending upon whether the distribution is a periodic or nonperiodic distribution. For periodic distributions, the wage withholding tables found in Circular E apply, and for nonperiodic distributions, the rate of withholding is 10 percent.

Responsibility to Withhold

Generally, the plan administrator of a qualified plan and the payor of a 403(b) plan or 457(b) plan has the responsibility to withhold an amount equal to 20 percent of the portion of an eligible rollover distribution that is not paid in a direct rollover to another plan. However, the plan administrator may shift the burden of withholding to the payor by directing the payor to withhold and furnishing the payor with any information necessary to withhold the proper amount.⁴⁸

Traditional IRA Distributions Exception

The mandatory 20-percent withholding applicable to eligible rollover distributions from employer plans does *not* apply to a distribution from an IRA. Under existing rules, withholding will generally apply to any IRA distribution at the rate of 10 percent, unless the payee is eligible for and elects for no-withholding to apply.⁴⁹

\$200 *De Minimis* Rule

Employers may but need not exclude eligible rollover distributions that are reasonably expected to total less than \$200 during a year from the direct rollover option and the 20-percent mandatory withholding requirement. All eligible rollover distributions received within one taxable year of the distributee under the same plan must be aggregated for purposes of determining whether the \$200 floor is reached.⁵⁰ However, as an eligible rollover distribution, these amounts could possibly be eligible for a rollover (although the amount is not subject to mandatory withholding).

Withholding Requirement on Property Distributions

If all or a portion of an eligible rollover distribution consists of property other than cash, employer securities, or plan loan offset amounts; and is subject to the 20-percent withholding requirement, the employer must sell the property (except employer securities) in amounts sufficient to pay the withholding. However, no withholding is required when the eligible rollover distribution consists solely of employer securities and cash less than \$200.

⁴⁸ Treas. Reg. Section 31.3405(c)-1, Q&A 4 and 5; Treas. Reg. Section 35.3405-1T, Q&A E-2 through E-5.

⁴⁹ Treas. Reg. Section 31.3405(c)-1, Q&A 1; Form 1099-R, *Instructions*.

⁵⁰ Treas. Reg. Sections 1.401(a)(31)-1, Q&A 11, 31.3405(c)-1, Q&A 14.

Payment of Withholding to Payor by Participant

If a distribution consists of property (other than employer securities), the payor or plan administrator could permit the payee to remit to the payor or plan administrator sufficient cash to satisfy the withholding obligation.

Distributions of Employer Securities

The maximum amount to be withheld on any designated distribution, including eligible rollover distributions, must not exceed the sum of the cash and the fair market value (FMV) of the property (excluding employer securities) received in the distribution. Although the value of employer securities is included in the amount that is multiplied by 20 percent, the amount to withhold from an eligible rollover distribution is limited to the sum of the cash and the FMV of property excluding employer securities. If the entire distribution represents employer securities and \$200 or less in cash, no withholding is required.

Distributions to Nonspouse Beneficiaries and Alternate Payees

A distribution made to a nonspouse beneficiary is not eligible to be rolled over or paid as a direct rollover to another plan. Therefore, these distributions do not constitute eligible rollover distributions and are not subject to the 20-percent mandatory withholding requirement. Instead, distributions to nonspouse beneficiaries would be subject to the voluntary withholding rules.⁵¹

If a nonspouse is an alternate payee with respect to a QDRO, such amounts are also not eligible rollover distributions. The plan participant is treated as the distributee and is subject to income taxes, as follows:⁵²

Because the distribution to a nonspouse alternate payee is includible in the gross income of the participant, no part of such distribution may be rolled over by the nonspouse alternate payee. However, the participant may roll over such amounts by making a contribution to an eligible retirement plan if the requirements of the Code are otherwise satisfied.⁵³

Reliance on Adequate Information Provided by the Employee

The plan administrator will not be subject to liability for taxes, interest, or penalties for failure to withhold income taxes from an eligible rollover distribution merely because the distribution is paid to an account or plan that is not an eligible retirement plan. Although the plan administrator is not required to verify independently the accuracy of information provided by the employee, the plan administrator's reliance on the information furnished must be reasonable.⁵⁴ The employee must furnish the necessary information to the plan

⁵¹ Treas. Reg. Section 1.402(c)-2, Q&A 12(b).

⁵² IRC Section 402(e)(1)(B).

⁵³ IRS Notice 89-25, Q&A 4.

⁵⁴ Treas. Reg. Section 31.3405(c)-1, Q&A 7.

administrator in order for a direct rollover to be accomplished. This includes providing the name and address of the recipient plan trustee or custodian.

Direct Rollovers

Direct Rollover Procedure

An employer's direct rollover may be accomplished by any reasonable means of delivery to the new eligible retirement plan, including a wire transfer or the mailing of a check to the new recipient plan. If payment is made by check, the check must be negotiable only by the trustee or issuer of the recipient plan. If payment is made by wire transfer, the wire transfer may only be directed to the trustee or issuer of the recipient plan. The delivery of a check to the new plan by the employee is also permitted, provided that the payee line of the check is made out in a manner that will ensure that the check is negotiable solely by the trustee or custodian of the recipient plan.⁵⁵ A direct rollover payment should be made payable as follows:

[Name of trustee/custodian] as [trustee/custodian] FBO [name of participant] [name of recipient plan]

An example is, "GalacticBank as Trustee FBO William Jefferson Clinton, IRA."

If the recipient plan is not an IRA, the payee line of the check need not identify the trustee by name. For example, a check may read "Trustee of XYZ Corporation Profit Sharing Plan FBO Jane Doe" if such direct rollover is being made to that plan.

Caution: *Do not issue direct rollover payments to broker-dealer, as payee, that are not the named custodian or trustee of the recipient plan.*⁵⁶

Splitting Distributions Under the \$500 Rule

An employer must permit an employee to elect to have a portion of an eligible rollover distribution paid in a direct rollover to another plan and have the remaining amount paid directly to the employee. However, the employer need not follow this requirement if the portion to be paid in a direct rollover to another plan is less than \$500.⁵⁷

Direct Rollovers to Multiple Recipient Plans

An employer may but is not required to permit the employee to elect a direct rollover into more than one recipient plan. Thus, the plan administrator may

⁵⁵ Treas. Reg. Section 1.401(a)(31)-1, Q&A 3 & 4.

⁵⁶ Treas. Reg. Section 1.401(a)(31)-1, Q&A 3 & 4.

⁵⁷ Treas. Reg. Section 1.401(a)(31)-1, Q&A 9.

require that the distributee select a single plan to which the eligible rollover distribution (or portion thereof) will be paid in a direct rollover.

Example. An employer's plan requires an employee to select one traditional IRA into which the entire eligible rollover distribution will be paid. The employee could then directly transfer from that traditional IRA a portion of the traditional IRA to another plan to achieve the desired result.⁵⁸ The one-rollover per year rule only applies to rollovers between IRAs.

Election Deadline and Default Procedure

A plan administrator is permitted to establish a default procedure in the event a distributee does not make an affirmative election to make or not to make a direct rollover.⁵⁹ The default procedure can include, for example, that if the distributee does not make the affirmative election within 90 days of the IRC Section 402(f) Notice, such amount will be distributed subject to the 20-percent withholding or that such amount will be automatically distributed in a direct rollover to an eligible recipient plan. If the plan administrator wishes to have such a default procedure, such default must either be part of the 402(f) Notice or a separate explanation that must be received by the distributee in conjunction with the 402(f) Notice.

The employer is also permitted to establish a deadline after which the employee may not revoke an election to make or not make a direct rollover. However, such a deadline may not be more restrictive than that which otherwise applies under the plan to revoke the form of distribution elected by the participant.

An employer may treat the employee's election to make or not to make a direct rollover with respect to one payment in a series of periodic payments which qualify as eligible rollover distributions as applying to all payments in the series if:

- The employee may change the election at any time with respect to subsequent payments; and
- The required 402(f) Notice explains that the election to make or not to make a direct rollover will apply to all future payments which are eligible rollover distributions unless the employee changes the election.

Prohibition Against Employer Impairing a Direct Rollover

An employer or plan administrator may not in any way impair the employee's availability of electing a direct rollover. Impermissible procedures include:⁶⁰

1. Requiring the distributee to obtain an attorney's opinion that the eligible retirement plan receiving the rollover is an eligible recipient plan

⁵⁸ Treas. Reg. Section 1.401(a)(31)-1, Q&A 10.

⁵⁹ Treas. Reg. Section 1.401(a)(31)-1, Q&A 7 and 8.

⁶⁰ Treas. Reg. Section 1.401(a)(31)-1, Q&A 6.

2. Requiring the recipient plan that, upon request, the plan will automatically return any direct rollover amount that the distributing plan advises the recipient plan was paid incorrectly
3. Requiring the recipient plan to provide a letter indemnifying the distributing plan for any liability arising out of the distribution

If too much is rolled over to an IRA, the result is an excess contribution, which must be corrected under IRC Section 408(d)(4) along with the earnings attributable to the excess amount. It would appear that the ineligible amount should be treated as contribution to a traditional IRA, subject to the annual contribution limit under IRC Section 219.

IRC Section 402(f) Notice

The IRS provides a model notice and safe-harbor explanation for employers and plan administrators to use to satisfy the required IRC Section 402(f) notification to recipients of eligible rollover distributions. The 402(f) Notice may not be posted.⁶¹ The IRC Section 402(f) Notice must be designed to be easily understood and must contain a written explanation of:⁶²

1. The availability of the direct rollover option
2. The rules that require income tax withholding on eligible rollover distributions which are not paid in a direct rollover to an eligible plan
3. The rules under which the distributee may roll over the distribution within 60 days of receipt
4. If applicable, the other special tax rules (e.g. grandfathered 10-year averaging) that may apply to the distribution, including treatment of net unrealized appreciation on employer's securities

An employer may use the word-for-word identical language provided by the IRS, or the employer may customize the notice by omitting those provisions that do not apply under the employer's plan. Employers may also add additional language to the notice so long as the additional information is not inconsistent with the safe harbor notice or IRC Section 402(f).

The employer/plan administrator is required to provide the safe-harbor notice "within a reasonable time" before making an eligible rollover distribution. *Reasonable time* has been defined to be generally no less than 30 days and no more than 90 days before the distribution date. However, employees may waive the application of the 30-day "holding" period by making an "affirmative election" to make or not make a direct rollover provided that:

- The participant is given at least 30 days to decide.

⁶¹ Treas. Reg. Section 1.402(f)-1, Q&A 4.

⁶² Treas. Reg. Section 1.402(f)-1, Q&A 1.

- The plan administrator states in writing that the participant has a right to the 30-day period to make the decision. An obvious place for this statement is on the 402(f) Notice. The written notice must be provided individually to any distributee of an eligible rollover distribution.⁶³

With respect to a series of periodic payments that are eligible rollover distributions, (i.e., total payments less than 10 years), the plan administrator is required to distribute the 402(f) Notice prior to the first payment and generally provide the notice at least once annually for as long as the payments continue.⁶⁴

For returns, reports, and other statements which are due for years after December 31, 1996, the plan administrator is subject to a \$100 penalty (\$50,000 maximum per year) for each failure to provide the 402(f) Notice at such time and in such manner as required.

Model 402(f) Notices for Qualified Plans and 403(b)s

Model notices explaining pension rollover right were issued in Notice 2002-3.⁶⁵ There is a separate 402(f) Notice for 457(b) plans. In Announcement 2002-46, the IRS provided a safe-harbor explanation in Spanish that plan administrators can provide to Spanish-speaking employees who are recipients of eligible rollover distributions from qualified employer plans, tax-sheltered annuities or governmental section 457(b) plans to satisfy IRC Section 402(f).⁶⁶

Rollovers and Direct Rollovers by Surviving Spouse Beneficiaries

If a surviving spouse beneficiary of a deceased plan participant receives an eligible rollover distribution, all of the rollover and direct rollover provisions generally apply as if the surviving spouse were the participant. Thus, the surviving spouse beneficiary can roll or direct roll to a traditional IRA or into an employer's plan in which the spouse participates if that plan accepts rollovers.⁶⁷

Rollovers and Direct Rollovers by Alternate Payee Under a QDRO

If a spouse or former spouse of a plan participant is to be treated as the recipient of an eligible rollover distribution pursuant to a QDRO (usually in connection with a divorce or similar proceeding), such alternate payee is treated under the same rules as the plan participant for purposes of a rollover or direct rollover. This also includes the ability of the alternate payee spouse or former

⁶³ Treas. Reg. Section 1.402(f)-1, Q&A 4.

⁶⁴ Treas. Reg. Section 1.402(f)-1, Q&A 3. See exceptions to one year rule.

⁶⁵ 2002-2 IRB 289.

⁶⁶ 2002-28 IRB 96.

⁶⁷ IRC Section 402(c)(9) and Treas. Reg. Section 1.402(c)-2, Q&A 12(a).

spouse to elect a direct rollover into another employer's plan of the alternate payee that accepts such rollovers or to a traditional IRA plan.⁶⁸

The Recipient Plan Is Not Required to Accept the Funds

Although the employer's plan must provide employees the option to elect a direct rollover of an eligible rollover distribution to another eligible plan, there is no requirement that the recipient plan accept such direct rollovers.⁶⁹ Thus, a recipient plan can refuse to accept rollovers and direct rollovers. In addition, a recipient plan can limit the circumstances under which it will accept rollovers and direct rollovers. For example, a recipient plan can limit the types of plans from which it will accept a rollover or direct rollover, or limit the types of assets it will accept in a rollover (such as only cash).

Plan Must Allow for a Distribution

The expanded portability rules do not require that a distribution be made. In other words, the employer's plan must permit the distribution to be made. For example, profit-sharing plans may allow for in-service distributions, while money-purchase plans may only provide for a distribution after retirement.

IRS Reporting

Although a *direct rollover* is being paid from an employer's plan directly to an IRA or another employer's plan (in other words, the employee is not in actual receipt of the distribution), it is still treated as a reportable distribution and subsequent rollover to another plan.⁷⁰

Disqualification Relief for Plans Accepting Direct Rollovers

Treasury Regulations provide relief from disqualification if the plan accepts a defective rollover, but only if the following requirements are satisfied:⁷¹

1. *Direct Rollover From Another Qualified Plan.* A letter from the distributing plan should be received which provides that either:
 - a. The distributing plan has received an IRS determination letter (but the recipient plan is not required to receive a copy of the determination letter); or
 - b. The distributing plan satisfies (or is intended to satisfy) IRC Section 401(a), and the plan administrator is not aware of any provision or operation that would result in disqualification.
2. *60-Day Rollover Received From the Participant.* The participant must certify that, to the best of the participant's knowledge:

⁶⁸ IRC Section 402(e)(1)(B) and Treas. Reg. Section 1.402(c)-2, Q&A 12(a).

⁶⁹ Treas. Reg. Section 1.401(a)(31)-1, Q&A 13.

⁷⁰ Treas. Reg. Section 31.3405(c)-1, Q&A 15, 16, 17.

⁷¹ Treas. Reg. Section 1.401(a)(31)-1, 1.402(c)-2.

- a. The participant was entitled to the distribution as an employee, not as a beneficiary.
 - b. The distribution was not one of a series of periodic payments.
 - c. The distribution was received not more than 60 days before the rollover contribution.
 - d. The entire amount being rolled over would have been taxable had it not been rolled over.
3. *Rollover From a Conduit IRA.* The participant must also certify that the rollover into the conduit IRA:
- a. Was made not more than 60 days after the employee received the original distribution.
 - b. No amounts other than the qualified plan distribution were contributed to the conduit IRA (unless the plan accepts rollovers from other types of plans).
 - c. The rollover contribution made to the new qualified plan was made within 60 days after the distribution from the conduit IRA.

If a plan accepts a defective rollover, the receiving plan will not be disqualified, under two conditions. First, the plan administrator of the receiving plan reasonably concludes that the contribution is a valid rollover (based upon the above criteria). Second, the plan administrator of the receiving plan distributes the invalid rollover amount, plus any earnings, to the employee within a reasonable time after the rollover was determined to be invalid.

Default Direct Rollovers Upon Involuntary Cashout

A qualified plan may be amended to allow for a default method of payment in a direct rollover to an IRA, if the participant fails to affirmatively elect to make a direct rollover or to receive a cash payment of an involuntary cashout (generally amounts not in excess of \$5,000).⁷²

Example. An employer maintains a defined-contribution plan that does not accept any after-tax contributions or any other monies that would not be subject to tax at the point of distribution. The plan will be amended to provide for a default direct rollover if a participant separates from service, has more than \$1,000 but less than \$5,000 at the point of termination, unless the participant elects otherwise.

Responsibilities of Employer and IRA Trustees

A default direct rollover provision must be described in the summary plan description, the plan document, and the IRC Section 402(f) Notice. The 402(f) Notice must also contain the name, address, and telephone number of the IRA trustee or custodian, and describe any maintenance or withdrawal fees im-

⁷² Rev. Rul. 2000-36 (2000-2 C.B. 140).

posed by the IRA and how funds will be invested. A default direct rollover must not occur for less than 30 days and not more than 90 days after the date the 402(f) Notice is given to the participant.

The employer is also permitted to establish a deadline after which the employee may not revoke an election to make or not to make a direct rollover. However, such a deadline may not be more restrictive than that which otherwise applies under the plan to revoke the form of distribution elected by the participant.⁷³

The employer may execute the IRA paperwork on behalf of the participant. A similar rule applies for SEP plans and SIMPLE IRAs if the participant refuses to set up an IRA or cannot be found.⁷⁴ Not all IRA trustees or custodians will allow an employer to establish an IRA on behalf of an employee. It is incumbent upon an employer under such circumstances to find an IRA trustee or custodian that will accept a default direct rollover before completing the required notice.

Disregarding Rollovers for Purposes of the \$5,000 Cashout Limit

A plan is permitted to exclude rollover balances (including earnings) in determining whether or not a participant's benefit exceeds \$5,000 for purposes of the involuntary cashout rules of IRC Section 411(a)(11).

Related Rollover and Direct Rollover Issues

Lump-Sum Distributions From Qualified Plans

Although Congress modified and expanded the types of eligible rollover distributions and implemented the direct rollover option and the 20-percent mandatory withholding requirement, taxpayers may still be eligible for favorable tax treatment (10-year averaging and/or capital gains) on certain lump-sum distributions from qualified plans.⁷⁵ See Chapter 4, "Qualified Plans in General," for more information.

60-Day Rollover Requirement

If an eligible rollover distribution is paid to the recipient rather than paid as a direct rollover to another plan, the taxable amount is still eligible to be rolled over. The rollover contribution must be made, however, no later than the sixtieth calendar day *after* the distribution was actually *received* by the individual (not the date on the check). The 60-day rollover period applies separately

⁷³ See, IRC Section 401(a)(31)(B). On January 7, 2003, the DOL issued proposed rules on automatic default rollovers (68 Fed. Reg. 4, 991-994). Section 657(c) of the EGTRRA 2001 directed the DOL to develop, through regulations, safe harbors relating to the automatic rollovers of certain mandatory tax-qualified plan distributions to individual retirement plans. Under these safe harbors, the designation of an institution and the investment of funds by a plan administrator to receive automatic rollovers in accordance with IRC Section 401(a)(31)(B) would be deemed to satisfy the fiduciary requirements of ERISA Section 404(a).

⁷⁴ Prop. Treas. Reg. Section 1.408-7(d)(2).

⁷⁵ IRC Section 402(d), repealed for tax years after December 31, 1999.

to *each* eligible rollover distribution as it is received by the distributee.⁷⁶ The date of receipt is determined by the recipient and need not be proved by the receiving plan's trustee or custodian. If the sixtieth day falls on a weekend or legal holiday, the rollover must be completed no later than the last business day immediately prior to the weekend or legal holiday.

The employer or payor is required to withhold 20 percent of the eligible rollover distribution that was paid to the recipient. Since the 20-percent withheld amount is considered part of the eligible rollover distribution, the individual may include an amount equal to the amount that was withheld in order to roll over the entire taxable amount of the distribution.

Exception for Frozen Deposits

The 60-day rollover period described above is extended if the individual is unable to withdraw the funds due to the money becoming frozen after the distribution is received but before the rollover is completed. The term *frozen deposit* means any deposit which may not be withdrawn because of the bankruptcy or insolvency (or threat thereof) of any financial institution. The 60-day period will not include any period during which the deposit is frozen or end earlier than 10 days after such amount ceases to be a frozen deposit.⁷⁷

Exception for Certain Disasters

A taxpayer's 60-day rollover period may be extended in cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to the rollover period.⁷⁸

Waiver of 60-Day Rule

The IRS may waive the 60-day requirement if the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. In determining whether to grant a waiver of the 60-day rollover requirement, the IRS will consider all relevant facts and circumstances, including:⁷⁹

- Errors committed by a financial institution
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error

⁷⁶ IRC Section 402(c)(3); Treas. Reg. Section 1.402(c)-2, Q&A 11.

⁷⁷ IRC Section 402(c)(7).

⁷⁸ IRC Sections 402(c)(3)(B), 408(d)(3)(I).

⁷⁹ IRC Sections 408(d)(3)(A)(ii) (the 60-day rule), 408(d)(3)(D) (partial rollovers permitted within 60 days), 408(d)(3)(I) (waiver of 60-day requirement); Rev. Proc. 2003-16, 2003-4 IRB 359; Rev. Proc. 2003-1, 2003-1 IRB 1 (procedures for issuing letter rulings); Rev. Proc. 2003-8, 2003-1 IRB 236 (user fee schedule); Ltr. Ruls. 200401020 and 200401023 (financial institution error), 200401024 (mental illness based on principles of equity or good conscience), 20040102 (Incapacity due to Alzheimer's disease).

- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed)
- The time elapsed since the distribution occurred

The taxpayer is not required to submit an application (by private letter ruling) to the IRS, provided:

1. A financial institution receives funds on behalf of a taxpayer prior to the expiration of the 60-day rollover period.
2. The taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan).
3. Solely due to an error on the part of the financial institution, the funds are not deposited into an eligible retirement plan within the 60-day rollover period.

Automatic approval is granted only if:

1. The funds are deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period
2. It would have been a valid rollover had the financial institution deposited the funds as instructed.

Distribution of Property

In general, if an eligible rollover distribution consists of both cash and property (such as stock), the assets rolled over must consist of the same property distributed. Unlike property distributions from IRAs, property distributed from an employer's plan may be sold and the proceeds from the sale may be rolled over.⁸⁰ However, the proceeds from the sale would be used to determine the maximum amount eligible for rollover, whether it is more or less than the FMV of the property on the date of distribution.

Fluctuations in Fair-Market Values

In most cases involving property distributions, the value of the property at the time of distribution (for purposes of Form 1099-R) is different from the value of the property (or the proceeds from the sale of the property) on the date of the rollover contribution (for purposes of Form 5498). The taxpayer is still responsible for properly reflecting a rollover on his or her federal income tax return. Therefore, the person's tax preparer should probably provide a line item explanation and attach it to the appropriate year's return identifying the possible reasons why the Forms 1099-R and 5498 do not match.

⁸⁰ IRC Section 402(c)(6).

Replacing Distributed Property With Cash

The recipient of an eligible rollover distribution may not retain the property distributed and roll over cash representing the FMV of the property. The property rolled over must either be the actual property received in the distribution, or the proceeds from the bona fide sale of the distributed property.⁸¹

Net Unrealized Appreciation in Employer Securities Distributed From a Qualified Plan

Although the plan's cost basis for purposes of determining the NUA may be composed of varying costs of shares purchased in different years, the shares distributed have a new basis which is the same for each share received in the distribution.⁸² This new basis would be used for purposes of determining gain or loss on a subsequent sale or other taxable disposition.⁸³

Even if the net unrealized appreciation portion of a distribution is excluded from gross income, the NUA would be included as part of an eligible rollover distribution. However, to the extent that the NUA portion is excludible from gross income, the NUA portion is not a "designated distribution" subject to withholding, because it is reasonable to believe that it is not includible in gross income. As a result, to the extent that the NUA portion is excludible from gross income, the NUA portion is not included in the amount of an eligible rollover distribution that is subject to the 20-percent withholding requirement. Therefore, if the distribution consists solely of employer securities and \$200 or less in cash in lieu of fractional shares, no withholding is required.

Although a rollover (including a direct rollover) will make a lump-sum distribution ineligible for forward income averaging,⁸⁴ there is no similar prohibition in the rules that provide for exclusion of NUA from income. The IRS has expressly ruled that a rollover of the other assets received in a lump-sum distribution, even if through a direct rollover, will not preclude the participant from deferring recognition of the NUA in the shares retained (not rolled over).⁸⁵

A rollover of some of the employer securities is possible. If the participant rolls over some of the employer securities, then a pro-rata allocation of the NUA, based on the number of shares retained, should be allocated to the securities which are not rolled over.⁸⁶

Example. Darleen receives a lump-sum distribution from her employer's qualified plan. The distribution consists of 100 shares of her employer's secu-

⁸¹ Rev. Rul. 87-77.

⁸² IRC Section 402(e)(4); Treas. Reg. Sections 1.402(c)-2 Q&A 3(b)(3), 31.3405(c)-1, Q&A 12.

⁸³ Rev. Rul. 57-114.

⁸⁴ IRC Section 402(d)(4)(K).

⁸⁵ Ltr. Rul. 9721036 (Feb 27, 1997); Ltr. Rul. 200003058 (Oct. 29, 1999)

⁸⁶ Ltr. Rul. 200038057.

rities. The average cost basis of each share in the plan's trust is \$50, and the FMV on the date of distribution is \$100. The possible outcomes are as follows:

1. Darleen rolls over the 100 shares to a traditional IRA. She will lose NUA treatment. Her distribution from the IRA will be fully taxable.
2. Darleen decides to keep 50 shares and rollover the remaining 50 shares to a traditional IRA. She will lose NUA treatment on the shares rolled over. The shares that were not rolled over will continue to retain their individual average cost basis of \$50.
3. Darleen decides to retain the full amount of the NUA by keeping 50 shares having a value equal to the total NUA of \$5,000 (50 x \$100) and rolling over the remaining 50 shares. Darleen cannot attribute the NUA to specific shares. Darleen will lose NUA treatment on the shares rolled over. The shares that were not rolled over will continue to retain their individual average cost basis of \$50.

Distributions Other Than Lump Sum

Generally, the exclusion of NUA is not available for distributions that are not lump-sum distributions. However, to the extent that after-tax employee contributions were made by the employee, the exclusion of NUA is available only on the NUA resulting from employee contributions, other than deductible voluntary employee contributions.

Qualifying Lump-Sum Distributions That Include After-Tax Employee Contributions

A participant who has made after-tax employee contributions and receives a qualifying lump-sum distribution of employer securities must keep track of the value of the after-tax employee contributions if such stock is rolled over to a traditional IRA. This value increases the taxpayer's basis in his or her IRA for determining subsequent taxable IRA distributions.

Rolling Over All Securities Except the Portion Representing After-Tax Contributions

A participant who receives employer securities in a qualifying lump-sum distribution and who has made nondeductible employee contributions must allocate the NUA between employee and employer contributions.

Example. Ryan receives a lump-sum distribution with a total FMV of \$46,000. This amount consisted of \$4,000 in cash and \$42,000 in company stock. The cost basis of the stock is \$24,000, and the NUA is \$18,000. Ryan made \$10,000 nondeductible employee contributions to the plan. The total taxable amount of the distribution is \$18,000, computed as follows:

$$\begin{aligned} & \$4,000 \text{ cash} + \$42,000 \text{ stock FMV} - \$18,000 \text{ NUA} \\ & - \$10,000 \text{ nondeductible employee contributions} = \$18,000 \end{aligned}$$

Since the total cost of the stock was \$24,000, \$10,000 of which represented the employee's nondeductible contributions, the amount is attributable to the employee's contributions can be computed as follows:

$$5/12 (\$10,000 / \$24,000) \times \$18,000 = \$7,500$$

The remaining \$10,500 (\$18,000 – \$7,500) is attributable to contributions made by Ryan's employer.

If Ryan wants to roll over the taxable amount but recognize the deferral of NUA on his after-tax contributions, he would need to roll over the \$4,000 cash, plus \$24,500 of the stock (\$24,000 total cost basis at distribution – \$10,000 after-tax employee contributions + \$10,500 NUA value on employer contributions). In this example, the resulting basis in the stock not rolled over is \$10,000, and the NUA attributable to the nondeductible employee contributions is \$7,500. Upon a subsequent sale of the stock, \$7,500 is taxed at the long-term capital gains rate and any additional gain is taxed at either the short- or long-term capital gains rate depending upon the actual holding period since the stock was distributed to Ryan from the plan.

Stepped-Up Basis of Employer Stock Held Until Death

If an employee receives a qualifying distribution of employer securities and the NUA is excluded from the employee's gross income (as discussed above), the basis in the stock going forward is the value that was taxed upon distribution (the plan's original cost basis of the stock).

At the employee's death (assuming that the stock is still being held by the individual at that time), the stepped-up basis rules provide that only the appreciated value of the employer stock after it was distributed from the plan receives a step-up in basis when the heirs, subsequent to the employee's death, sell the stock. The IRS has ruled that the original NUA that was excluded from the employee's gross income when it was first distributed from the plan does not receive a step-up in basis. Thus, the NUA retains its original character even after the employee's death, and will constitute income in respect of a decedent when the heirs sell the stock.⁸⁷

Example. Butch received a qualifying lump-sum distribution from his employer's qualified plan that consisted entirely of employer securities. On distribution, the FMV of the stock was \$100,000 and had a cost basis of \$20,000. The NUA portion of the stock distributed was \$80,000. Butch included in gross income the cost basis of \$20,000 and excluded the NUA portion of \$40,000.

Butch still held the employer's stock upon the date of his death. On his date of death, the stock had appreciated in value to \$140,000. If Butch's heirs decide to sell the stock several months later, the stock was worth \$150,000. The stepped-up basis for the heirs when the stock is sold is \$60,000 (\$140,000

⁸⁷ Rev. Rul. 75-125.

date of death value – \$80,000 NUA). The \$80,000 NUA is included in the gross income of the heirs, but the heirs may be able to take a tax deduction on their federal income tax return as income in respect of a decedent.

The additional \$10,000 gain from the date of Butch's death to the date his heirs sold the stock is also included in the gross income of the heirs. Thus, \$90,000 (\$80,000 NUA + \$10,000 additional gain) is taxable to the heirs as long-term capital gains.

No Rollover and Direct Rollover of Amounts Subject to Required Minimum Distribution Rules

Any amount which is required to be distributed under IRC Section 401(a)(9) is not an eligible rollover distribution. All amounts distributed during a year for which a minimum is required to be distributed are treated as the minimum amount from that plan and are not eligible to be rolled over to another plan.⁸⁸

Thus, if any required minimum amounts are rolled over or paid as a direct rollover to another plan, the taxpayer is subject to income taxes without regard to the rollover and direct rollover. And if the recipient plan is an IRA, such required minimum is treated as an excess IRA contribution subject to the 6-percent excise tax each year until the excess is corrected.

If a participant has not received his or her MRD prior to receiving an eligible rollover distribution and a portion of the distribution is excludible from gross income (nondeductible employee contributions), then the portion of the distribution that is excludible from gross income is first allocated toward the required minimum amount.⁸⁹ This has the result of allowing the participant to roll over more of the distribution.

Example. Nick, a participant in a qualified plan is eligible to receive a \$4,800 distribution, \$4,000 of which is his required minimum distribution (RMD) for the year. The administrator determines that \$1,000 of the distribution is excludible from gross income for the year due to the return of nondeductible employee contributions. First, the \$1,000 return of basis is allocated toward satisfying the RMD. Then the remaining \$3,000 of the RMD is satisfied from the \$3,000 of the distribution that is includible in gross income. This leaves the remaining amount of \$800 as an eligible rollover distribution if it otherwise qualifies.

Plan Administrator May Make Certain Assumptions

A plan administrator is permitted to determine the amount of a RMD for any calendar year by assuming that there is no designated beneficiary.⁹⁰ This means that the "Uniform Lifetime Table" (previously known as the MDIB table) would be used to determine the required minimum. Although the plan administrator calculates the portion of a distribution that is an RMD by as-

⁸⁸ IRC Section 402(c)(4)(B); Treas. Reg. Section 1.401(a)(9)-7 and IRS Notice 93-3.

⁸⁹ Treas. Reg. Section 1.402(c)-2, Q&A 8.

⁹⁰ Treas. Reg. Section 1.401(a)(31)-1, Q&A 17(c) and 1.402(c)-2, Q&A 15.

suming that there is no designated beneficiary, the portion of the distribution that is actually a required minimum and is not an eligible rollover amount is determined by taking into consideration the designated beneficiary, if any. Therefore, if a greater portion of the distribution is an eligible rollover distribution by taking into account the designated beneficiary, the distributee may roll over the additional amount.

Withdrawing More Than the Minimum

Any payments which exceed the required minimum amount are eligible rollover distributions (unless another exception applies) and thus could be subject to the 20-percent withholding. The portion representing the minimum is subject to the voluntary withholding rules:

If a participant in an individual account plan is required under 401(a)(9) to receive a minimum distribution for a calendar year of \$1,000 and the participant receives four quarterly distributions in that year of \$400 each, then the first two distributions and \$200 of the third distribution are not eligible rollover distributions. However, the remaining \$200 of the third distribution and all of the fourth distribution are eligible rollover distributions because this is the amount by which the total of the distributions exceeds the required minimum distribution.⁹¹

Direct Rollover Can Be Immediately Rolled Again

The restriction of only one rollover within a 12-consecutive month period applies *only* to rollovers between IRA.⁹² Therefore, if a rollover or direct rollover is made from an employer's plan into an IRA plan, the IRA holder can immediately roll (or direct transfer) that IRA into another IRA. As a matter of fact, the individual could even "revoke" the newly established IRA within the first seven days, and the IRA trustee or custodian would not be allowed to charge any fees, although the revoked distribution would be reportable on Form 1099-R as fully taxable. This is true even though the participant had to irrevocably elect to treat the original rollover or direct rollover to the IRA as a rollover contribution.⁹³

Participant Loans Treated as Distributions

Participant loans in an employer plan can produce two types of distributions; a deemed distribution of a loan in default or a distribution of a loan offset amount.⁹⁴

A *deemed distribution* occurs if IRC requirements governing participant loans (e.g., amount of repayment, frequency of payments, and so on) are not satisfied. Such deemed distribution is treated as a distribution for federal income tax purposes and not as a distribution of the participant's accrued bene-

⁹¹ IRS Notice 93-3.

⁹² IRC Section 408(d)(3)(B); Treas. Reg. Section 1.402(c)-2, Q&A 16.

⁹³ Pursuant to Treas. Reg. Section 1.402(a)(5)-1T.

⁹⁴ Treas. Reg. Sections 1.402(c)-2, Q&As 4(d) and 9, 1.401(a)(31)-1, and Q&A 15 and IRS Notice 93-3.

fit under the plan. In general, a deemed distribution is not an eligible rollover distribution, and, therefore, is not subject to the 20-percent withholding requirement.

Example. Timothy has a balance of \$20,000 in his employer's plan. \$6,000 is invested in a participant loan. If Timothy defaults on the loan by not making a loan payment under the terms of the plan or loan policy, \$6,000 is a deemed distribution subject to federal income taxes. However, this \$6,000 deemed distribution is not an eligible rollover distribution and not subject to the 20-percent mandatory withholding. Timothy will receive a Form 1099-R indicating the defaulted loan amount as taxable.

A *distribution of an offset amount* occurs if, under the terms of the plan or the plan's loan policy, the participant's accrued benefit under the plan is reduced (offset) in order to pay off the loan. Such an offset could occur, for example, in the case of a participant separating from service or requesting a distribution from the plan. A distribution of an offset amount is an eligible rollover distribution and subject to the mandatory 20-percent withholding to the extent that the 20 percent can be taken from the remaining assets in the distribution.

Example. Roger has a balance of \$5,000 in his employer's plan. \$1,500 is invested in a participant loan. Roger separates from service and requests that his entire balance be paid in a direct rollover to an IRA. The \$1,500 loan amount is offset against his \$5,000 balance in the plan. Thus, \$3,500 is paid in a direct rollover to his IRA. Roger will receive a Form 1099-R from his employer's plan indicating that \$5,000 was distributed using Code 1 or 2 depending on his age. The \$1,500 offset amount may be rolled over to the IRA if Roger makes up the difference from other sources. If Roger does not make up the \$1,500 difference as a rollover to the IRA, Roger will pay income taxes on the \$1,500.

Example. Assume the same facts in the preceding example, except that Roger does not elect a direct rollover to his IRA. Instead, Roger requests that the balance be paid directly to him. In this case, the mandatory 20-percent withholding would apply to the entire \$5,000, and Roger would receive only a \$2,500 distribution amount, computed as follows:

$$\$5,000 - \$1,500 \text{ loan offset} - \$1,000 \text{ withholding on entire amount} = \$2,500$$

If Roger did not want any portion of the distribution to be taxable, he could roll over a full \$5,000 into his IRA within 60 days. However, he would have to come up with a difference of \$2,500.

Interest-Only Distributions

The present regulations do not specifically address whether or not interest-only distributions from qualified plans are eligible rollover distributions and

thus subject to the 20-percent withholding if they are not paid in a direct rollover to another plan.⁹⁵ Since interest-only distributions do not represent a series of payments over life or life expectancy, one could assume that interest-only payments would always be treated as eligible rollover distributions subject to the 20-percent withholding. On the other hand, it could be argued that interest-only distributions over a period of time which is expected to last for at least 10 years would not constitute eligible rollover distributions, and therefore, would be subject to the voluntary withholding rules.

Annuity Contract Distributed From Qualified Plan

A *qualified plan distributed annuity contract* is an annuity contract purchased for a participant and distributed to the participant by the qualified plan. Amounts paid under a qualified plan annuity contract are payments of the balance to the credit of the participant and are eligible rollover distributions, if they otherwise qualify.⁹⁶ For example, if the participant surrenders the contract for a single sum payment of its cash surrender value, the payment would be an eligible rollover distribution to the extent it is includible in income and not a required minimum amount. This rule applies even if the qualified plan distributed annuity contract is distributed in connection with a plan termination. If any amount to be distributed under a qualified plan distributed annuity contract is an eligible rollover distribution, the annuity contract must satisfy the direct rollover option rules in the same manner as the qualified plan. The payor under the contract is treated as the plan administrator. If amounts are distributed from a qualified plan distributed annuity contract which are eligible rollover distributions, the payor under the contract must comply with the mandatory 20-percent withholding requirement in the same manner as the plan administrator would have had under the qualified plan.

Restrictions on Certain Terminated Defined-Benefit Plans

When a defined-benefit plan is terminated within 10 years of its inception, the IRS has required, in some cases, that the highest paid 25 employees could not receive a distribution until such time as all plan benefits were paid to the other employees and/or all liabilities under the plan were satisfied.⁹⁷

In certain cases, however, the IRS permitted such restricted employees to enter into some kind of escrow agreement or security agreement which allowed these employees to roll over their accrued benefit under the plan into an IRA. This escrow or security agreement also prevented any distribution from the IRA for a certain period of time. The only involvement of the IRA trustee and issuer under these types of agreements has been to recognize any withdrawal restrictions of the agreement and abide by its terms.

⁹⁵ Treas. Reg. Section 1.402(c)-2, Q&A 5.

⁹⁶ Treas. Reg. Section 1.402(c)-2, Q&A 10, 1.401(a)(31)-1, Q&A 16, and 31.3405(c)-1 Q&A 13.

⁹⁷ Treas. Reg. Section 1.401(a)(4)-5(b), Rev. Ruling 92-76, Ltr. Rul. 9419040 (2/17/94).

Rolling Traditional IRAs Into an Employer's Plan

Beginning in 2002, certain distributions from traditional IRAs will be eligible for rollover into an employer's qualified plan, 403(b), or governmental 457(b).⁹⁸

The types of IRAs eligible for this rollover include traditional IRAs containing regular contributions, rollover IRAs containing rollovers from employer plans, SEP IRAs and SIMPLE IRAs (after the participant has met the two-year holding requirement applicable to SIMPLE IRAs). Roth IRAs and Coverdell ESAs cannot be rolled over to employer plans.

Maximum Amount Eligible to Be Rolled Over to an Employer's Plan

If the employer's plan accepts these rollovers, the maximum amount eligible to be rolled over from the above described IRAs is the amount that would otherwise be taxable to the individual.⁹⁹ The taxable amount is determined by aggregating all of the types of IRAs listed above. Amounts that would not be considered taxable include nondeductible IRA contributions and after-tax employee contributions that have been rolled over to an IRA from an employer's plan. The taxpayer is responsible for keeping track of any nontaxable basis amounts in his or her IRAs.

Caution: Provisions allowing amounts transferred to an employer's qualified plan, 403(b), or governmental 457(b), to be rolled back to a traditional IRA is scheduled to expire (sunset) after 2010. No guidance has been issued as to how such amounts would be treated or recovered from distributions from the plan.

Summary Charts

IRA Rollover Summary Chart

The following chart summarizes the rollover rules applicable to IRAs. It shows which types of IRA can be rolled over to other plans.

Employer Plan Rollover Summary Chart

The chart on the following page summarizes the rollover rules applicable to employer plans. It shows which types of employer plans can be rolled over to other plans.

⁹⁸ IRC Section 408(d)(3)(A)(ii).

⁹⁹ IRC Section 408(d)(3)(H).

Types of Plans	Permitted Rollover Plans							Roth IRA	Coverdell ESA
	Qualified Plan	403(b)	457(b)	TSP	Traditional IRA	SEP IRA	SIMPLE IRA		
Qualified Plan	Yes, if plan accepts. If after-tax, must be direct rollover	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes. No rollover of after-tax	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
403(b)	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. If after-tax, must be direct rollover	Yes, if plan accepts. No rollover of after-tax allowed	No	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
457(b)	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	No	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
TSP	No	No	No	Yes	Yes	Yes	No	No	No
Conduit IRA	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, only if entire IRA holds QP assets	Yes, but should keep separate	Yes, but should keep separate	No	Yes, as a conversion	No

Types of IRAs	Rollover Plans				 Taxable Amount Only		
	Trad. IRA	SEP IRA	SIMPLE IRA	Roth IRA	Coverdell ESA	Qualified Plan	403(b)	457(b)
Traditional IRA (including Conduit IRA and SEP IRA)	Yes	Yes	No	Yes, as a conversion	No	Yes, only if qualified plan accepts	Yes, only if 403(b) plan accepts	Yes, only if 457(b) plan accepts
SIMPLE IRA	Yes, only after 2 years	Yes, only after 2 years	Yes	Yes, as a conversion after 2 years	No	Yes, only if QP accepts, only after 2 years	Yes, only if 403(b) accepts, only after 2 years	Yes, only if Gov't 457(b) accepts, only after 2 years
Roth IRA	No	No	No	Yes	No	No	No	No
Coverdell ESA	No	No	No	No	Yes	No	No	No

Chapter 16

State Taxation of Nonresidents

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State Taxation of Nonresidents

This chapter discusses the taxation of distributions from tax-favored retirement plans, nonqualified plans, and mirror plans under the Pension Source Act.

Pension Source Act

The Pension Source Act¹ prohibits states (including political subdivisions of a state), the District of Columbia, and the possessions of the United States from imposing any income tax on the retirement income of an individual who is not a resident or domiciliary of the jurisdiction (as determined under the laws of that jurisdiction).² Making a nonresident pay tax on distributions of amounts deferred while he or she was a resident of a state is called *source taxation*.

Note. The Pension Source Act does not prevent a state from denying deductions for contributions made to a retirement or deferred compensation plan or from including the amount contributed currently in the participant's income. Thus, with only the front door closed, states are still able to walk in the back door by not allowing business deductions or by limiting exclusions from the employee's income (or both). In addition, it remains to be seen how aggressive states will be in determining if an individual is domiciled within a state and then subjecting the unprotected benefits to taxation.

Income Tax

The term *income tax* is defined broadly as “any tax levied on, with respect to, or measured by, net income, gross income, or gross receipts.”³

¹ Pub. L. No. 104-95, 109 Stat 979; Codified at 4 U.S.C. Section 114 and made applicable to amount received after December 31, 1995.

² 4 U.S.C. Section 110(d).

³ 4 U.S.C. Section 110(c).

Domicile

Because the statute provides that domicile or residence is determined under the laws of the state seeking to tax the pension distributions,⁴ and not under the laws of the distributee's state of domicile or residence, it is possible for an individual's retirement income to be subject to state income tax in two or more states,⁵ and a state is not required to give credit for tax paid to any other state.

Protected Income

There is no dollar limit on the amount of retirement income that can be treated as retirement income. The Pension Source Act defines *retirement income* as any income from:

1. An eligible deferred compensation plan set up by a state or local government or tax-exempt organization pursuant to Internal Revenue Code (IRC or the Code) Section 457
2. A qualified retirement plan under IRC Section 401(a)
3. A qualified annuity plan under IRC Section 403(a)
4. A simplified employee pension plan (SEP) under IRC Section 408(k)
5. A SIMPLE retirement account under IRC Section 408(p)
6. A tax-sheltered annuity plan under IRC Section 403(b)
7. An individual retirement account or annuity (IRA) under IRC Section 408
8. A government plan described in IRC Section 414(d) (These are plans set up by the United States government, a state or a political subdivision of a state, or any of their agencies or instrumentalities.)
9. A trust created before June 25, 1959, that is part of a plan funded only by employee contributions⁶
10. Certain retired or retainer pay of a member or former member of the uniformed services
11. A nonqualified plan, program, or arrangement subject to IRC Section 3121(v) (These are ineligible plans that benefit from special Social Security and unemployment tax rules, discussed later.)

The Pension Source Act protects "any income." Thus, death benefits, disability benefits, and any other payments from a tax-favored plan to a nonresident are shielded from state taxation. Payments to nonresidents from an ineligible mirror plan (discussed later) may also be protected from source taxation.

⁴ 4 U.S.C. Section 114(a).

⁵ *Texas v. Florida*, 306 U. S. 398, 83 L. Ed. 817, 59 S. Ct. 563, 830, 121 A. .L.R. 1179.

⁶ See IRC Section 501(c)(18).

Nonqualified Deferred Compensation Plans

Protection from source taxation may also be available on distributions from an ineligible plan, none of which are listed above. The term *retirement income* also includes income from a nonqualified deferred compensation plan, provided such income is one of the following:⁷

1. Part of a series of substantially equal periodic payments (not less frequently than annually) made for:
 - a. The life or life expectancy of the recipient (or the joint lives or life expectancies of the recipient and the recipient's beneficiary), or
 - b. A period not less than ten years
2. A payment received after termination of employment from certain types of mirror plans (discussed later)

The definition of *periodic payments* under the Pension Source Act⁸ is nearly identical to that of *periodic payments* that are excludable from the definition of *eligible rollover distribution* with respect to a qualified plan, IRC Section 403(b) plan (403(b) plan), and eligible governmental IRC Section 457 plan (457 plan) distributions.⁹ Thus, for example, payments that could not be rolled over because of the periodic payment rules if they were made from a qualified plan will qualify for the pension source taxation. In addition, the following generally qualify as periodic payments:

- Disability benefits qualify, even though it is generally not known how long disability will last.¹⁰
- Social Security supplements will not disqualify an otherwise qualifying periodic payment stream and will be considered to qualify.¹¹
- Distributions made from an individual account plan until the account is exhausted will qualify if, based on reasonable actuarial assumptions, they may be expected to last at least 10 years.¹²
- In the case of a split distribution, such as an immediate lump-sum payment of \$20,000 with the balance payable in 10 annual installments, the installment payments qualify.¹³
- Certain one-time payments, such as a large initial retroactive check covering several months of benefits, or a "13th check" in the nature of a cost-of-living supplement, may be treated as part of the periodic payment stream.¹⁴

⁷ 4 U.S.C. Section 114(b)(I).

⁸ 4 U.S.C. Section 114(b)(I)(i).

⁹ IRC Sections 402(c)(4)(A); Treas. Reg. Section 1.402(c)-2, Q&As-3, 5, and 6.

¹⁰ Treas. Reg. Section 1.402(c)-2, Q&A-5.

¹¹ Treas. Reg. Section 1.402(c)-2, Q&A-5(b).

¹² Treas. Reg. Section 1.402(c)-2, Q&A-5(d).

¹³ Treas. Reg. Section 1.402(c)-2, Q&A-6(a).

¹⁴ Treas. Reg. Section 1.402(c)-2, Q&A-6(b).

Nonqualified Plans

By definition, a *nonqualified plan* is “any plan, program, or arrangement described in Code Section 3121(v)(2)(C),” other than, in general, the various forms of tax-favored retirement plans described above. Under that section, special Social Security and unemployment tax rules generally provide that contributions are taken into account at the time the associated services were performed, or, if later, when no longer subject to a substantial risk of forfeiture. Gain is not taken into account under the special Social Security and unemployment tax rules.

Final Treasury regulations contain extensive guidance on the meaning of “plan of deferred compensation” for Federal Insurance Contributions Act (FICA) tax purposes.¹⁵ It appears that this guidance also will apply in determining when payments to nonresidents qualify for protection against state income taxes under the Pension Source Act.¹⁶

IRC Section 3121(v)(2)(C) defines *nonqualified deferred compensation plan* as any plan or other arrangement established and maintained by an employer that provides for the deferral of compensation. The final regulations impose additional requirements:

- *Written Plan Requirement.* A plan (including a plan that covers a single employee) is established as of the latest of (1) when it is adopted, (2) when it is effective, or (3) when its material terms are set forth in writing (or any other form approved by the Commissioner of Internal Revenue).¹⁷
- *Legally Binding Right.* A plan provides for the deferral of compensation only if the employee has a legally binding right during the year to compensation that has not been actually or constructively received and that is payable in a later year under the plan. Whether the arrangement is elective or nonelective is irrelevant. However, if an employer can unilaterally reduce or eliminate the benefit, other than by “operation of the objective terms of the plan” (e.g., an offset to qualified plan benefits, forfeiture schedule), the plan does not provide for deferred compensation within the meaning of IRC Section 3121.

In general, the rules do not impose a minimum deferral period (beyond the next tax year) before payments will qualify for the special Social Security tax rules. Benefits paid for current services, and benefits established after services are performed, are both generally excluded from the definition.

¹⁵ Treas. Reg. Section 1.3121(v)(2)-1(b).

¹⁶ Mazawey, “New Federal Limitations on State Taxation of Retirement Income,” 22 *J of Pension Planning & Compliance* 2 (Summer 1996) 1.

¹⁷ Treas. Reg. Section 1.3121(v)(2)-1(b).

Mirror Plans

A mirror plan is a nonqualified retirement plan maintained by an employer for providing benefits in excess of certain limits on contributions and benefits contained in the Code that apply to qualified retirement plans. The benefits provided under a mirror plan are those that would have been provided under the terms of a qualified retirement plan (including certain designated tax-sanctioned retirement plans) but for the application of the following limits on contributions and benefits:

- IRC Section 403(b) limits the amount of annual contributions that can be made to a tax-sheltered annuity (maintained by certain tax-exempt entities and public educational organizations). In addition to the IRC Section 415 limit on employer and employee contributions, which applies to tax-sheltered annuities, there is an annual dollar limit on elective contributions. For 2004, this limit is \$13,000, but it may be increased slightly (up to \$3,000 to a \$15,000 lifetime limit) if the employee has completed at least 15 years of service with a qualifying organization. The \$13,000, increasing \$1,000 per year up to \$15,000 in 2006, and the amount is adjusted for cost of living thereafter.
- IRC Section 415 limits the amount of annual contributions that can be made to a participant in a defined-contribution plan and the benefits that can be provided to a participant under a defined-benefit pension plan. The annual defined-contribution limit is \$41,000 or 100 percent of compensation for 2004, plus catch-up contributions. For 2004, the maximum annual benefit that can be provided under a defined-benefit plan is generally the lesser of 100 percent of the high three-years' average compensation (a limit that does not apply to governmental plans) or \$165,000, payable in the form of a straight life annuity with no ancillary features. Under that section, the participant's employer is considered to maintain the contract if the participant has more than 50-percent control of the employer.¹⁸ Thus, contributions to the tax-sheltered annuity program may have to be combined with all contributions made to qualified plans to determine whether the IRC Section 415 limitations have been exceeded.
- IRC Section 401(a)(17) limits the amount of annual compensation that can be taken into account under a qualified retirement plan for purposes of computing benefits and contributions to \$205,000 for 2004.
- IRC Section 401(k) limits the amount of elective deferrals (contributions at the election of the employee) that can be made by a highly compensated employee (HCE) to a qualified cash or deferred arrangement (commonly called a 401(k) plan) according to a nondiscrimination test based on the amount of such contributions made on behalf of nonhighly compensated employees (NHCEs).

¹⁸ Within the meaning IRC Section 414(b) or (c) (as modified by IRC Section 415(h)); see IRC Section 415(k)(4).

- IRC Section 408(k) limits the amount of elective deferrals that can be made by a HCE to a salary-reduction or elective simplified employee pension plan (SARSEP) according to a nondiscrimination test based on the amount of such contributions made on behalf of NHCEs.
- IRC Section 401(m) limits the amounts of employer matching contributions and after-tax employee contributions that can be made to a 401(k) plan on behalf of HCEs according to a nondiscrimination test based on the amount of such contributions made on behalf of NHCEs.
- IRC Section 402(g) limits the total annual amount of elective deferrals that can be made to a 401(k) plan (and similar arrangements) generally to \$13,000 for 2004, plus catch-up contributions if age 50 or older.

Maintained Solely for Providing Benefits in Excess of the Limitations

In the absence of regulations, determining when a plan is maintained solely for the purpose of providing retirement benefits in excess of the limitations discussed above or any other limitation on contribution or benefits under the Code on plans to which such sections apply may be difficult to ascertain. Fortunately, the periodic payment rule (discussed above) assumes that these amounts are not subjected to state income tax upon distribution. Commentators have suggested that employers may have to split their nonqualified plans into two or more arrangements to get the protection and benefit offered by the Pension Source Act.¹⁹

Arguably, a plan that contains a nonprotected benefit would not qualify under the maintained solely rule. As a consequence, distributions from such a plan could be subject to state source taxation. It also remains to be seen how aggressive states will be in determining when an individual is domiciled within a state and in subjecting unprotected benefits to taxation.

Termination From Service

In-service payments under a window plan are not protected from source taxation. Only payments after termination of service from a plan that is maintained solely for the purpose of providing benefits in excess of limitations on contributions or benefits in the Code are protected by the Pension Source Act.

¹⁹ Lesser, "State Taxation of Pension Income Curtailed," 4 *J of Taxation of Employee Benefits* 2 (July/Aug 1996) 88; Mazawey, "New Federal Limitations on State Taxation of Retirement Income," 22 *J of Pension Planning & Compliance* 2 (Summer 1996) 1.

Chapter 17

Creditor Protection

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Creditor Protection

Creditor protection in qualified plans and individual retirement account or annuity-based (IRA) retirement plans is discussed in this chapter. The meaning of the term employee with the rights of a participant under the Employee Retirement Income Security Act of 1974 (ERISA) has been recently addressed by the U.S. Supreme Court. Most, but not all employer-based plans, are exempt from creditor protection. If the plan is not subject to ERISA, other rules may apply. IRA exemption generally depends upon state law.

ERISA Coverage

Self-employed individuals are treated as employees under the Internal Revenue Code (IRC or the Code) for purposes of establishing and participating in a plan.¹ A working owner, such as a sole proprietor, or partner, or sole-shareholder, who renders services to a business may also be a participant in an ERISA plan, and treated as an *employee* with the rights of a *participant* under ERISA.²

¹ IRC Section 401(c)(1).

² *Yates v Hendon* (U.S. Supreme Ct, Docket No. 02-458). On January 13, 2003, the U.S. Supreme Court heard oral arguments on whether a sole shareholder and president in a professional corporation is an employee with rights as a participant in an ERISA plan. If so, the plan assets would not be part of the debtor's bankruptcy estate. The Sixth U.S. Court of Appeals had concluded that the bankruptcy trustee could reach the money in the plan, because "as an 'employer, a sole shareholder cannot qualify as a 'participant or beneficiary' in an ERISA pension plan." See, too, the brief for the United States as *Amicus Curiae* in *Yates MD PC Profit Sharing Plan (et al) v William T. Hendon, Trustee* (No-02-458, 6th Cir) (http://supreme.lp.findlaw.com/supreme_court/briefs/02-458/02-248.pet.ami.usa.html), which includes DOL Ad Op 99-04A (Feb 4, 1999) regarding the definition of *participant* if an owner or owners provide personal services. The brief was in response to the court's order inviting the Solicitor General to express the views of the United States. A decision in the case is expected by July 2004. *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon, Trustee* (02-458), 287 F.3d 521, reversed and remanded (2004). The question presented in *Yates* was whether a working owner of a business is an ERISA plan 'participant' and thus has the right to enforce the plan's anti-alienation provisions against a bankruptcy trustee. The Sixth Circuit had said no to this question in its 2002 decision (287 F.3d 521) and its decision was in conflict with nine other circuits. In March 2004, the Supreme Court issued a 9-0 decision reversing the holding in *Yates*, as long as the plan covers one or more employees other than the business owner and his or her spouse (as it did in *Yates*). In *Yates*, the Sixth Circuit incorrectly held that the holding of *Patterson v. Shumate*, 504 U.S. 753, did not apply because plan participant Dr. Raymond B. Yates was not an 'employee' as defined in ERISA because he owned all of the stock of his professional corporation, which sponsored the plan, and therefore was not a 'participant' in an ERISA-qualified pension plan. The Sixth Circuit's ruling was based on an erroneous interpretation of DOL Reg. Section 2510.3-3 (29 U.S.C. §1001(b)). See, too, the brief for the United States as *Amicus Curiae* in *Yates MD PC Profit Sharing Plan (et al) v William T. Hendon, Trustee* (No-02-458, 6th Cir) which includes DOL Ad Op 99-04A (Feb 4, 1999) regarding the definition of *participant* if an owner or owners provide personal services. The brief was in response to the court's order inviting the Solicitor General to express the views of the United States.

Under Title I of ERISA, the term *employee benefit plan* does not, however, include plans in which no employees are participants covered under the plan, or in which only a sole proprietor or only partners are participants. Furthermore, in such case, an individual and the individual's spouse are not deemed to be employees with respect to a trade or business (whether incorporated or unincorporated), that is wholly-owned by the individual or by the individual and his or her spouse. Also, if there are no common-law employees in a partnership, neither a partner nor a partner's spouse is considered an employee with respect to the partnership for ERISA Title I coverage purposes.³ In nearly all cases, a plan with one or more common-law employees is considered an *employee benefit plan* under ERISA.

Qualified Retirement Plans

Bankruptcy

The U.S. Supreme court has held that a participant's interest in an ERISA-qualified retirement plan is exempt from the claims of creditors in a bankruptcy proceeding.⁴ In analyzing whether the pension plan was qualified at the time that the debtor filed his bankruptcy petition, the court in *Hall*⁵ began by noting that even though the Supreme Court conclusively decided that an ERISA-qualified plan is not part of the bankruptcy estate, it did not address what is or is not an ERISA-qualified plan. Relying on the Sixth Circuit's decision in *In re Lucas*,⁶ which predated but was consistent with the Patterson opinion, the court held that an ERISA-qualified plan must be (1) subject to ERISA; (2) tax-qualified under IRC Section 401; and (3) include an anti-alienation provision.^{7, 8}

State bankruptcy exemptions may go even farther. In one case, a distribution from a qualified plan was protected under state bankruptcy exemption during 60-day rollover period.⁹ To be exempt, some courts have required that the plan be ERISA covered, others that it merely be (or had been) a qualified plan, others have required both ERISA coverage and qualification under the Code. The plan should also contain an enforceable anti-alienation provision.¹⁰

³ DOL Reg. Section 2510.3-3; *Gaudette v Erricola*, No 999-354-B (D NH 2000).

⁴ *Paterson v. Shumate*, 112 S Ct 2242 (1992) [Nonetheless, the meaning of the term qualified retirement plan is unclear. [*In re Kaplan*, 1993 Bank Lexis 1534 (Bankr Ed Pa 1993)].

⁵ *In re Hall*, 151 BR 412 (Bankr WD Mich. 1993).

⁶ *In re Lucas*, 924 F2d 597 (6th Cir; 1991).

⁷ *Id.* at 419; but see *In re Conner*, 73 F3d 258, 259 (9th Cir; 1996) (not requiring qualification under IRC to satisfy IRC Section 541(c)(2)).

⁸ See extensive discussion and state-by-state charts in Gideon Rothchild & Christopher Alliotts, "Protecting Retirement Plans" (<http://www.mosessinger.com/resource/protecting.shtml>).

⁹ *Wolff v. Gibson (In re Gibson)*, 2003 U.S. Dist. LEXIS 20219 (D. Md. 2003).

¹⁰ Gideon Rothchild & Christopher Alliotts, "Protecting Retirement Plans" (<http://www.mosessinger.com/resource/protecting.shtml>).

Creditor Protection

As a general rule, an attachment, garnishment, levy, execution, or other legal or equitable process of or against a participant's qualified retirement plan benefit violates ERISA's anti-alienation rule and could result in the disqualification of the plan.¹¹ However, a participant or beneficiary whose benefits are in pay status may make a voluntary and revocable assignment or alienation of up to 10 percent of future benefit payments, provided there is no direct or indirect defraying of administrative fees.¹²

Individual Retirement Accounts

IRC Section 201(6) or ERISA exempts an IRA from ERISA Title 1, Part 2 coverage. That part includes the anti-alienation provisions that provide protection from creditors. Thus, an IRA is not subject to ERISA's anti-alienation provisions.

Creditor Protection

Many states grant creditor protection for assets held in an IRA. Some state statutes provide an unlimited and unqualified exemption for an IRA; others may provide a qualified exemption. A state may limit the exemption by placing a specific percentage or dollar limitation on the exemption. Others provide that the exemption is valid except for contributions made within a certain number of days prior to the filing of the petition. Some states provide for IRA exemption to the extent of amounts reasonably necessary for the support of the debtor and the debtor's dependents.¹³

Bankruptcy

Under federal bankruptcy law, states can opt out of the federal exemption scheme and establish their own exemptions. Many states have granted exemptions for an IRA. Under federal bankruptcy law, an IRA is not protected.

Rollover IRA

Several courts have ruled that a rollover IRA is exempt from execution by judgment creditors under state law because ERISA does not apply and the state elected to opt out of the federal scheme. Other courts have denied protection; some have ruled that the portion rolled over from a qualified plan retained its exempt status.

¹¹ Treas. Reg. Section 1.401(a)-13(d)(1); Ltr. Ruls. 9011037, 8829009.

¹² ERISA Section 206(d); IRC Sec 401(a)(13)(A); Treas. Reg. Section 1.401(a)-13(d)(1); see Employee Benefits Security Administration (EBSA), formerly the Pension Welfare Benefits Administration (PWBA) Ad Op 94-41A (Dec 7, 1994) regarding escheat.

¹³ For additional information, see the Investment Company Institute State Survey of IRA Protection in Bankruptcy at http://www.ici.org/issues/ret/arc-leg/00_state_bankrupt_surv.html#TopOfPage. The state by state survey includes IRA, Roth IRA, SEP IRA, SIMPLE IRA, and Coverdell Education Accounts.

SEP and SIMPLE IRA

Creditor Protection

Most states offer protection from creditors for assets held in an IRA that is established and maintained by a participating employee for the holding of simplified employee pension plans (SEP) IRA or savings incentive match plan for employees (SIMPLE) IRA contributions.¹⁴

Bankruptcy

Under federal bankruptcy law, states can opt out of the federal exemption scheme and establish their own exemptions. Many states have granted exemptions for an IRA that is established in connection with a SEP IRA or SIMPLE IRA.

Under federal bankruptcy law, a SEP is not protected. A number of courts have held that a SEP, although a pension plan for purposes of ERISA, is exempt from ERISA's anti-alienation provision and was subject to forfeiture because ERISA's anti-alienation provisions do not apply to IRAs, including SEPs.¹⁵ In *Lampkins v. Golden*, the Sixth Circuit held that a SEP is governed by ERISA and hence federal preemption eliminates the protection from creditors that otherwise would be provided by a state exemption statute.¹⁶ The appellate court held that although an IRA that is part of a SEP arrangement is not subject to ERISA's anti-alienation provision, it is subject to ERISA's preemption provision.¹⁷ The Sixth Circuit held a relevant Michigan statute, non-garnishment of SEP assets, was preempted by ERISA because it related to an ERISA plan. The Eleventh Circuit, nearly a decade ago, also held that ERISA creditor protection does not extend to a SEP IRA.¹⁸ So far, no court has addressed a situation involving an IRA with both SEP and non-SEP contributions; perhaps an equitable allocation of the account is justified in such circumstances.¹⁹

Federal Liens

The IRS can enforce a federal lien against an IRA or qualified plan.²⁰ The IRS will generally only levy qualified plan benefits in flagrant and aggravated cases and if the amount exceeds \$6,000.²¹ Amounts distributed from an IRA or qualified plan, even if used to satisfy a federal lien, are subject to the 10-

¹⁴ *Lampkins v. Golden*, 28 Fed App LEXIS 409, 2002 WL 74449 (6th Cir, Jan 17, 2002).

¹⁵ *U.S. v. Norton*, 2002 WL 31039138, No. 2:99CV10078 (W.D.Va. 2002).

¹⁶ 2002 U.S. App. LEXIS 900 (6th Cir. 2002).

¹⁷ ERISA Section 514.

¹⁸ *In re Schlein*, 8 F.3d 745 (11th Cir. 1993).

¹⁹ See Alvin J. Golden, "Piercing Shield Laws to Garnish SEP-IRAs," *Trusts and Estates*, Aug 2002, 51, 52-53.

²⁰ IRC Section 6334; Chief Counsel Advice 200102021, 200041029, 200032004, 199936041, 199930039.

²¹ See IRM 536(14).5 and 536(14).

percent premature distribution penalty if the IRA owner or participant is under age 59½, unless an exception applies.²² Arguably, the assessment or lien would have to arise prior to death (when a participant's rights are extinguished) and the beneficiary (other than the participant's or owner's estate) becomes the owner of the account.²³

²² Chief Counsel Notice N(36)000-2 (Jan 21, 2000).

²³ For additional information, see, Krass, Steven J, *The Pension Answer Book*, Q&As 4:25-4:28, 30:48, 34:40 (2004 Ed, Aspen Publishers, NY)

Chapter 18

Entity Choice—To Be or Not to Be

BY CHERIE O'NEIL, PH.D., CPA

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Entity Choice—To Be or Not to Be

By **CHERIE O'NEIL, PH.D., CPA**

The choice of entity decision is one of the most important decisions facing owners of small businesses. There are several forms to choose from, and each has different legal and tax consequences. No one form of entity is appropriate for every kind of business. Making this assessment requires an understanding of not only the major tax and nontax aspects of each form of business, but also how the comparative advantages and disadvantages of each relate to the needs of a specific client. The limited liability company (LLC) has become a popular entity choice because it offers the limited liability of a corporation with the single level of tax of a partnership. Members of an LLC can be taxed either as general partners, subject to self-employment tax, or as limited partners, exempt from self-employment tax, depending upon their level of participation in the business.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA or the Act) retroactively reduced the individual marginal tax rates for the tax year 2003 to 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent, set the 15-percent bracket for joint filers and the basic standard deduction to twice the single filer amounts. In addition, the Act reduced the tax rate on capital gains to 15 percent for taxpayers in the 25-percent or higher tax bracket and to only 5 percent for taxpayers in the 10-percent and 15-percent brackets. The Act did not make any changes to the corporate tax rate structure. The Act thus increased the preference for operating a business as a pass-through entity rather than as a regular C corporation.

Comparison of Entities¹

In many cases, there are tax benefits to operating a business as a flow-through entity, such as an LLC or an S corporation. If the business generates losses, deduction of losses by partners, LLC members, or shareholders is usually preferable to those losses offsetting only future corporate income. If the business generates profits, the direct taxation of partners or shareholders is usually preferable to the double taxation that is the norm for C corporations (i.e., taxation of the entity followed by taxation of shareholders if earnings are distributed). If the double tax can be mitigated, such as by paying out earnings as reasonable rent or salary, the use of a C corporation may be referable.

The major disadvantage of an S corporation is its lack of flexibility. The number and type of shareholders are severely restricted, and it may have only one class of stock. Special allocations of items of income or loss to particular shareholders are not permitted. In addition, because of the rules for determining basis, an S corporation shareholder may be unable to deduct losses and is more likely to recognize gain from the distribution of property than a partner or a member of an LLC.

A major disadvantage of a general partnership is that partners are jointly liable for the debt of the partnership. This is not always a problem since personal liability may be mitigated by insurance or other means. If the liability of partners for the debts of the partnership is a problem, a limited partnership may be the solution, provided the limited partners restrict their participation in the management of the partnership or risk the loss of their limited liability. An LLC may offer the best of both worlds, namely, limited liability for all members in addition to taxation as a partnership.

Nontax Factors

Formalities of Existence

Of the major forms of business, C and S corporations have the most burdensome requirements regarding the formalities of existence. A corporation is a separate legal entity from its owners and must file articles of incorporation with the secretary of the state in the jurisdiction of organization. Accordingly, it must also adopt bylaws, elect a board of directors, hold organizational meetings, and keep minutes thereof. In addition, each state has its own incorporation requirements that must be examined and observed. A general partnership usually has no formal registration requirements and may be established informally without a written agreement. A limited partnership, as a creature of state statute, must observe certain formalities. In particular, a certificate of limited partnership must be filed with the secretary of the state of

¹ Acknowledgment: Portions of this article appeared in "Entity Choice after the Jobs and Growth Tax Relief Reconciliation Act of 2003," published in *TAXPRO Quarterly Journal* (Summer 2003) 17–23. Reprinted with permission.

formation. The LLC must similarly follow the organizational requirements imposed by state law.

Limited Liability of Owners

In general, the owners of a C or an S corporation are not personally liable for the entity's obligations. However, an owner who guarantees a debt or commits a tort while acting on behalf of the entity may lose this protection. Limited liability may be lost if the entity either is undercapitalized or fails to maintain a separate identity from its owners. Since LLCs are state-created entities, there is little uniformity from state to state with respect to the extent of the limited liability of its members. Unlike a corporation or a LLC, a general partnership does not afford its owners limited personal liability. Its partners are personally liable for partnership debts and for the acts of fellow partners performed in furtherance of partnership business. General partners in a limited partnership have the same type of personal liability, as do their counterparts in a general partnership. The liability of limited partners who do not participate in the management of the business is limited to the extent of their investment.

Ability to Raise Capital

The regular corporation has the greatest ability to raise capital because, unlike the S corporation, there are no limits on the number or types of shareholders it may have. Also, a regular corporation has the ability to issue different kinds of stock, such as preferred stock, to attract new investors, while S corporations are prohibited from having more than one class of stock. Partnerships and LLCs may find it extremely difficult and time-consuming to amend the partnership agreement in order to raise additional capital by admitting new partners or members.

Participation in Management

In a regular corporation, the management of the business does not necessarily rest with the owners. Shareholder interests are protected by a board of directors, which makes broad policy decisions while leaving the day-to-day operation of the business up to management. Since the number of S shareholders is limited, it may be possible for a few shareholders to exercise control over the business. In a partnership or a LLC, the general partners act as both owners and managers and have significant input in how the business is run. Limited partners, on the other hand, act only to protect their investment interests and forgo any involvement in the operations of the business. If the investor is comfortable with a passive role, then a regular corporation or a limited partnership is preferable. An owner desiring a more active role in management should choose an S corporation or a general partnership.

Transferability of Interests

The free transferability of interests is the major advantage of a corporation. If stock is publicly traded, ownership interests can be bought and sold with ease.

For companies with stock that is not publicly traded, private placements are still possible. Unless the corporation is a professional service corporation, there is usually no restriction on who can own stock, making it possible to transfer ownership interests to relatives and business associates. Usually, the transfer of a partnership interest is more complex, since restrictions on transfers may be included in the partnership agreement. Also, it is much easier to transfer a portion of an ownership interest in a corporation which is stated in the number of shares owned. Dividing up a partnership interest is a more complex process, since the partnership agreement would have to be amended to reflect the new ownership interest of each partner.

Tax Factors

Tax Aspects Upon Formation

If either a C or an S corporation is formed, the owners generally contribute property or services to the entity in exchange for stock. If property is contributed, the owners do not recognize gain on receipt of the stock provided they are in control of the corporation, defined as owning 80 percent or more of the voting power and 80 percent or more of all other classes of stock. If the contributors receive something other than stock, (i.e., cash), gain is recognized to the extent of the nonqualifying property received. This rule also applies if the individual contributes property subject to debt, (i.e., the transferor is treated as having received cash equal to the amount of the debt). An individual who contributes services in exchange for stock must generally recognize gain. However, the corporation may be able to deduct the compensation to the extent it is not treated as a capital expenditure.

As most practitioners know, the tax consequences of forming a partnership or a LLC are similar to those governing corporate formation. A contribution of property to the entity in exchange for an ownership interest is generally not a taxable event. In addition, the partnership nonrecognition rules are more liberal than the corporate rules since there is no requirement that the owners be in control of the partnership after the contribution. If a partner contributes encumbered property to a partnership, the other owners' share of the liability is deemed to be distributed to the contributing owner. A partner who contributes services in exchange for a partnership interest generally recognizes gain equal to the value of the interest received. Similar to the corporation, a partnership may be able to deduct the compensation to the extent it is not treated as a capital expenditure.

Contribution of Property Examples

Example. A owns 40 percent of the stock in the ABC Corporation. She transfers land to the corporation with a fair market value (FMV) of \$10,000 and a basis of \$4,000. She recognizes gain of \$6,000 on the transfer because, after

the transfer, she does not meet the 80-percent control test. Her basis in the shares of stock issued for the land is \$10,000.

Example. A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a FMV of \$10,000, an adjusted basis to A of \$4,000, and was subject to a mortgage of \$2,000. The mortgage was assumed by the partnership. The basis of A's interest in the partnership is \$2,400, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less portion of mortgage assumed by other partners, which must be treated as a distribution (80 percent of \$2,000).	<u>(1,600)</u>
Basis of A's interest	\$2,400

Example. If the property contributed by A were subject to a mortgage of \$6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of \$6,000)	<u>(4,800)</u>
	\$ (800)
Recognized gain	<u>\$ 800</u>
Basis of A's interest	\$ 0

Since A's basis cannot be less than zero the \$800 in excess of basis is considered as a distribution of money under Internal Revenue Code (IRC or the Code) Section 752(b) and is treated as capital gain from the sale or exchange of a partnership interest, which increases her basis to \$0.

Example. A acquired a 20-percent interest in an S corporation by contributing property. At the time of A's contribution, the property had a FMV of \$10,000, an adjusted basis to A of \$4,000, and was subject to a mortgage of \$2,000. The corporation assumed the mortgage. The basis of A's stock is \$2,000, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less mortgage assumed corporation	<u>(2,000)</u>
Basis of A's interest	\$2,000

Example. If the property contributed by A were subject to a mortgage of \$6,000, A must recognize a gain of \$2,000, and her basis in the stock would be zero, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less portion of mortgage assumed by corporation	<u>\$6,000</u>
	-2,000
Recognized gain	<u>\$2,000</u>
Basis of A's interest	\$ 0

Tax Aspects Upon Sale

The tax preference for qualified small business stock (QSBS) issued after August 11, 1993, and held by the taxpayer for five years, was repealed by the 2003 Act. After May 5, 2003, these gains are eligible for the 15-percent capital gains tax rates.

Loss on the sale (or worthlessness) of stock usually results in a capital gain or loss subject to a \$3,000 per year deduction for capital losses in excess of capital gains. Loss on the sale of an unincorporated business, such as a sole proprietorship, reflects the sale of the underlying business assets and may be eligible for ordinary loss treatment under IRC Section 1231.

IRC Section 1244 provides similar ordinary loss treatment for shareholders in certain small business corporations in which the equity capital at the time of stock issuance does not exceed \$1 million. IRC Section 1244 stock ownership offers more favorable tax results than debt should the enterprise fail. The maximum loss allowed each year is \$100,000 if married filing joint, or \$50,000 if single. If the IRC Section 1244 stock loss exceeds the individual's taxable income for the year, the excess is allowable in computing a net operating loss under IRC Section 172, which can be carried back or carried forward.

Taxation as a Separate Entity Versus a Pass-Through Entity

One of the main factors affecting the choice of entity is whether its items of income, credit, loss, and deduction should pass through and be reported by the owners on their personal tax returns. One disadvantage of a C corporation is that its earnings are taxed twice—once when earned at the corporate level and again when distributed to shareholders. This double taxation may be minimized in the context of a closely held corporation if the entity pays out most or all of its earnings as (deductible) salary (the amount must be reasonable) or rent. S corporations and partnerships provide pass-through treatment. In general, there is no entity-level tax so the earnings are taxed once at the owners' marginal rates. Unlike S corporations, partnerships permit special allocations of tax attributes provided such allocations have substantial economic effect. Such allocations can often help a business raise equity capital

from outside investors while enabling the general partners to maintain control of the business. Pass-through entities are often good choices for businesses expected to generate losses in the early years because the active owners ordinarily can deduct those losses against income from other sources.

Taxation of Owner Compensation

An owner of a C corporation can be compensated through salary, fringe benefits, pension and profit-sharing plans, and dividends. Of these types of compensation, dividends are usually the least preferred because they are subject to tax at both the entity and shareholder levels. Salaries, to the extent they are reasonable in amount, are effectively taxed only once (as income to the owner) because they are deductible by the entity.

The net income attributable to the owners of a flow-through entity is subject to the following different self-employment tax rules:

- A sole proprietor's net income from self-employment whether distributed or not is subject to self-employment tax.
- Wages paid by an S corporation are subject to Federal Insurance Contributions Act (FICA) tax, but an S corporation shareholder's distributive share of income is excluded from self-employment income.
- A general partner's distributive share of trade or business income is includible in self-employment income, as are guaranteed payments.
- A limited partner's distributive share of trade or business income is excluded from self-employment income.
- An LLC member's distributive share of trade or business income is included in self-employment income unless the member is not a manager of the LLC. Generally, 10 percent or less owners of a LLC are exempt from self-employment tax unless they receive a guaranteed payment for services rendered.

Ability to Provide Tax-Favored Fringe Benefits

A C corporation has the greatest ability to provide fringe benefits on a tax-favored basis. Most types of fringe benefits, and pension and profit-sharing plans receive tax-favored treatment in that they can be paid with pretax dollars and often do not generate current income to the recipient. Such benefits include life insurance (with limits), health insurance and medical expense reimbursement plans, certain death benefits, and meals and lodging, in limited circumstances. A corporation can also set up a cafeteria plan to let employees choose among various fringe benefits. This flexibility is much greater than that afforded partnerships and S corporations. In general, a partnership may deduct the cost of providing benefits to the owners, but the partners must include the value of such benefit in income. Thus, the only tax benefit may be income shifting among the partners. This same rule applies to 2 percent or greater shareholders of an S corporation. In addition, contributions by the

corporation to a qualified pension plan may also be deductible when made but not currently taxable to the employee.

Sole proprietors, general partners, S corporation shareholder employees, and C corporation shareholder employees are all treated as employees for retirement plan purposes. A sole proprietor is treated as his or her own employer for retirement plan purposes. However, a partner is not an employer for retirement plan purposes; rather, the partnership is treated as the employer of each partner. Whether the entity chooses to fund retirement benefits with IRA-based plans, such as payroll deduction individual retirement accounts or annuities (IRAs); savings incentive match plans for employees (SIMPLE); or simplified employee pension plans (SEP); or with qualified plans, such as 401(k)s, profit-sharing, money-purchase, defined-contribution or defined-benefit plans, depends upon the desired funding level rather than upon any limitation imposed by the type of entity chosen.

Evaluating the Various Entity Forms

Although this may already be familiar to most practitioners, we provide a brief review here, as these issues pertain to the retirement plan arena.

The S Corporation

An S corporation is essentially identical to a C corporation in terms of the way it functions and with regard to the nontax consequences of doing business in corporate form. It offers investors limited liability and its operation and structure (a board of directors, officers, and shareholders) are similar to those of a C corporation. S corporations differ dramatically from C corporations with regard to tax matters. Unlike a C corporation, an S corporation is a pass-through entity. As such, the corporation essentially acts as a conduit through which items of tax attributes flow pro rata to shareholders. For startup corporations expected to generate losses in the early years, the S corporation is often preferable to a C corporation because losses from an S corporation flow through to shareholders and can be used to offset other income of the shareholders (or their spouses). Losses of a regular C corporation can only be used to offset profits earned in prior or subsequent tax years. Since a startup corporation has no prior profits to absorb losses, it must wait until some future profitable tax year to obtain any tax benefit from its losses. Double taxation of corporate earnings is avoided because there is generally no corporate-level income tax. Instead, earnings are taxed once at the shareholder level when earned regardless of when they are distributed.

Unlike a C corporation, an S corporation has limits on the number and types of permissible shareholders. It cannot have more than 75 shareholders, issue more than one class of stock, or have corporations, partnerships, non-resident aliens, and most types of trusts as shareholders. These restrictions, in turn, limit the transferability of shareholder interests in the corporation since a transfer to an ineligible shareholder would cause the S corporation to

lose its S status. Thus, although an S corporation has distinct tax advantages over a C corporation, many enterprises may not qualify for its use.

Incorporated professional practices, such as doctors, accountants, and lawyers, are typically called professional corporations or professional associations depending on the governing state law or preferences of the owners. A professional corporation can be either a C corporation or an S corporation. Although use of an S corporation may eliminate double taxation, it does prevent the owners from utilizing the more generous employee benefits available to C corporation employees. From a tax perspective, the primary advantage of using a corporation is the availability of tax-free fringe benefits. However, this must be weighed against the necessity of distributing profits to the shareholder employees to avoid the double taxation of income. The only nontax advantage of a professional organization is the limited liability its members may receive. Specifically, professionals in a group practice may achieve limited liability for their partners' professional malpractice, thereby protecting themselves from another partner's error or negligence.

The General Partnership

A general partnership provides multiple owners with the least costly and simplest type of entity. A partnership is a noncorporate entity comprised of two or more owners. Unlike a corporation, it requires no formalities in order to exist. Further, there is generally no limit on the type or number of owners in a partnership. Unlike a C or S corporation, partners in a general partnership are personally liable for the partnership's obligations. General partnerships are pass-through entities, and although the partnership must file an information return and characterize certain tax items at the partnership level, the partners, not the entity, deduct partnership losses on their income tax returns. Further, the use of a partnership avoids the double taxation of earnings problem found in C corporations. A general partnership is also preferable over other business forms because of the flexibility in the composition of the partnership.

Another advantage of a partnership is that it can specially allocate items of income, deductions, and losses among partners non-pro rata, provided the tests of IRC Section 704(b) are met. A contributor of money or property to a partnership can be allocated a disproportionate amount of the losses that the contribution has financed. However, the allocation must have "substantial economic effect" in order for it to be respected for tax purposes. In contrast, the requirement that an S corporation have only one class of stock prevents it from making allocations of gain or loss that are disproportionate to the shareholder's ownership in the corporation. An S corporation can issue debt, but care must be taken that it not be susceptible to being treated for tax purposes as a second class of stock, which would disqualify the S corporation election. In addition, the regular payment of interest required by a debt instrument may not be suitable for a new business.

For both partnerships and S corporations, losses are passed through to the equity owners and deducted by them on their tax returns. A partner cannot

deduct losses in excess of his adjusted basis in his partnership interest. However, this restriction usually does not cause a problem since partnership debt is included in the basis in a partnership interest. A shareholder of an S corporation cannot deduct losses in excess of his or her adjusted stock basis plus the adjusted basis of any loans made directly to the corporation. The basis of a shareholder's stock in an S corporation is not increased by the corporation's debt to third parties. Guarantees of corporate debt do not create basis until payments are actually made on the debt. This restriction on deductibility of a shareholder's losses from an S corporation is a significant limitation.

The Limited Partnership

The limited partnership offers the benefit of a partnership with the liability protection of a corporation. Like a corporate shareholder, limited partners in a limited partnership are not personally liable for the obligations of the partnership. The liability of the limited partners is limited to their financial investment in the enterprise. In addition, limited partnerships are pass-through entities that have no restrictions on the number or types of partners who may participate. In some cases, use of a limited partnership is preferable to a C corporation because the former has no entity-level tax. Thus, in contrast to a C corporation, its earnings are taxed once to the partners based on their respective distributive shares.

A major drawback of the limited partnership is the inability of the limited partners to participate in the management of the partnership. A limited partner may not vote on issues affecting the partnership's ordinary course of business. Because of the lack of participation in management, limited partners are subject to the passive loss rules of IRC Section 469. This severely restricts their ability to benefit from the tax credits and losses the entity may generate.

The Limited Liability Company

A LLC is a hybrid entity that is treated like a corporation for limited liability purposes, but is treated like a partnership for tax purposes. Like C corporations and limited partnerships, LLCs afford members limited liability. Unlike a limited partnership, a member of an LLC can participate in day-to-day management without losing limited liability. Equally important, an LLC, like an S corporation, is subject to only one level of taxation if properly structured. However, unlike an S corporation, there are no restrictions on the type or number of members. Despite all of the positive tax and nontax aspects of LLCs, there are some drawbacks. Because LLCs are creatures of state statute, legislation establishing and regulating these entities varies from state to state. This lack of uniformity among the states leads to unresolved tax and nontax issues.

Case Study

A comparison of the total income and Social Security taxes paid under each of the four entity choices was simulated for a hypothetical business owned by Dave and his spouse, Ellen, who file a joint tax return. Dave has a 90-percent

ownership interest in the business and Ellen has a 10-percent ownership interest. Dave takes a salary from the business while Ellen is a passive investor and receives no salary. It is assumed that the entity was operated for five years and then liquidated at the end of the fifth year. For the corporate form, it is assumed that the stock is redeemed rather than sold. Since the entire gain upon liquidation is taxed to the S shareholders, no gain or loss is recognized upon redemption of their stock.

The net present value of the total tax cost for each of the four entity choices was computed using four scenarios based upon the various combinations of the \$100,000 IRC Section 179 election-to-expense deduction and the 50-percent bonus depreciation deduction on personal property. The simulation also compares the present value of the total tax assuming that realty contributed to the business appreciated at 20 percent or at 0 percent per year. For ease of comparison, the results of the 32 simulations are shown as a percentage of the total taxes paid as a sole proprietorship—that is the sole proprietor tax is set at 100 percent.

Present Value of Total Tax as a Percentage of Sole Proprietor Tax Using Different Combinations of Bonus Depreciation and the Election to Expense

Entity Choice		
Asset Appreciation	20 Percent	0 Percent
50-Percent Bonus and \$100,000 Election-to-Expense		
Sole Proprietor	100%	100%
Partnership	95%	94%
S Corporation	96%	95%
C Corporation	138%	102%
Zero-Percent Bonus and \$100,000 Election-to-Expense		
Sole Proprietor	100%	100%
Partnership	99%	99%
S Corporation	98%	98%
C Corporation	142%	106%
Zero-Percent Bonus and Zero Election-to-Expense		
Sole Proprietor	100%	100%
Partnership	100%	100%
S Corporation	97%	96%
C Corporation	146%	111%

(continued)

**Present Value of Total Tax as a Percentage of Sole Proprietor Tax
Using Different Combinations of Bonus Depreciation and the
Election to Expense** *(continued)*

Entity Choice		
Asset Appreciation	20 Percent	0 Percent
50-Percent Bonus and Zero Election-to-Expense		
Sole Proprietor	100%	100%
Partnership	99%	99%
S Corporation	100%	100%
C Corporation	141%	105%

The simulations indicate a slight preference for the flow-through entity, either a partnership or an S corporation, since the total tax paid is less than 100 percent of the tax paid as a sole proprietor in twelve of the scenarios. The partnership (LLC) has the lowest present value of total taxes paid over the five-year time horizon in scenarios one and four, primarily resulting from income attributable to the limited partner is exempt from self-employment tax. One possible disadvantage of the LLC is that any operating loss attributable to the limited partner is not currently deductible because of the passive loss limitations under IRC Section 469. However, the disallowance of the passive loss may work to the taxpayer's advantage if it can be carried over to future tax years in which the entity generates net passive income from the LLC.

The loss generated in the first year as a result of claiming the maximum 50-percent bonus depreciation deduction does not reduce the Social Security taxes paid by the S corporation on the salary paid to the shareholder employee. Thus, it may be preferable to reduce salary payments when the 50-percent bonus depreciation is likely to generate a net loss. If bonus depreciation is not elected, under scenarios two and three, the S corporation is preferable to the partnership, because the total Social Security taxes paid on wages are less than those paid on the net self-employment income from the partnership.

Even though the tax treatment of fringe and retirement benefits favors using a regular C Corporation, it is the least favorable entity choice because current and liquidating dividend distributions are not deductible by the corporation. If the realty assets contributed to the partnership are appreciating at 20 percent per year, the built-in gain recognized in the year of sale causes the total tax of a regular C corporation to be between 38 percent and 46 percent more than the tax paid as a sole proprietor. If the assets are assumed to have no annual appreciation, the total tax of a regular C corporation is only 2 percent to 11 percent more than for the sole proprietor.

Conclusion

The choice-of-entity decision is a complex one with no one right answer for all businesses. It is important to weigh both the nontax and the tax factors when making this decision, including the net present value of the total tax cost of each entity choice. If nontax factors dictate that the corporate form be used, keeping appreciating assets, such as real estate, outside the corporation is preferable because of the corporate level tax on built-in gains. In lieu of contributing realty to the corporation, the shareholder could retain ownership of the assets and lease them to the corporation which would generate rental income and ensure that the gain upon their sale would be taxed only once. Also, it may be preferable to *not* elect the maximum IRC Section 179 election-to-expense or the 50-percent bonus depreciation deduction on all qualifying assets purchased during the tax year. Consideration should be given to taking the 50-percent bonus depreciation deduction on a selected few assets, so that bonus depreciation reduces taxable income to but not below zero.

It is widely assumed that the corporate form of doing business is preferable if the tax treatment of retirement and fringe benefits are taken into consideration. Nevertheless, the smallest total tax liability is achieved by choosing a flow-through entity, primarily because the double level tax on distributions can be avoided without adversely affecting retirement plan contributions.

Chapter 19

Deadlines for Depositing Employee Contributions and Loan Repayments

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Deadlines for Depositing Employee Contributions and Loan Repayments

This chapter primarily discusses the deadlines for making employee-derived contributions of plan assets to a plan under Department of Labor (DOL) and Internal Revenue Service (IRS) rules and regulations.

Plan Assets

The assets of the plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his or her wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets.¹ The DOL's deposits deadlines only apply to a plan covered by the Employee Retirement Income Security Act of 1974 (ERISA).

Deposit Deadlines for Elective Deferrals

ERISA regulations generally require employee contributions to qualified plans and salary-reduction or elective simplified employee pension plans (SARSEP) to be deposited as soon as they can reasonably be segregated from the employer's general assets, but in no event later than the fifteenth *business day* of the month following the month in which such amounts would otherwise have been payable to the participant in cash.² In the case of a savings incentive

¹ DOL Reg. Section 2510.3-102(a) [61 FR 41233, Aug. 7, 1996, as amended at 62 FR 62936, Nov. 25, 1997] for purposes of subtitle A and parts 1 and 4 of subtitle B of title I of ERISA and IRC Section 4975 only.

² DOL Reg. Section 2510.3-102(b)(1)], in the case of amounts withheld by an employer from a participant's wages.

match plan for employees (SIMPLE) individual retirement account or annuity (IRA), however, the deposit must occur no later than the thirtieth *calendar* day following the month in which the participant contribution amounts would otherwise have been payable to the participant in cash.³ The term *business day* means any day other than a Saturday, Sunday, or any day designated as a holiday by the federal government.⁴

Under the DOL's Voluntary Fiduciary Correction Program (VFCP), discussed fully in Chapter 12, "Plan Correction Programs—EPCRS, VFCP, and DFVC," one of the examples demonstrates how a failure to deposit elective deferrals with two business days after a payday was a fiduciary breach.⁵ One court, at least, has been more lenient.⁶ Prior deposit history appears to be significant in determining deposit deadlines. The IRS's Employee Plans Compliance Resolution System (EPCRS), discussed in Chapter 12, can also be used to correct qualification failures resulting from late deposits.

Contributions by Partners

If the plan asset regulations were proposed, comments were received by the DOL relating to when contributions by partners become plan assets. Under the final regulations, the monies that are to go to a qualified 401(k) plan by virtue of a partner's election become plan assets at the earliest date on which they can reasonably be segregated from the partnership's general assets after those monies would otherwise have been distributed to the partner, but no later than 15 business days after the month in which those monies would, but for the election, have been distributed to the partner. (See DOL Reg. Section 2510.3-102, Preamble.)

The following example illustrates how the rule might apply to a qualified plan (or a SIMPLE IRA or grandfathered SARSEP) maintained by a partnership. It is unclear to what extent a sole proprietor can rely on the regulations.

Example. The Lucky-7 Partnership maintains an elective Internal Revenue Code (IRC or the Code) Section 401(k) plan (401(k) plan). On December 31, 2004, the last day of its taxable and plan year, all the partners are under the age of 50 and individually elect to defer the maximum amount into their 401(k)s (not to exceed \$13,000 for 2004 per partner). During the year, each partner had a monthly draw of \$2,000 cash against eventual earnings. The firm's accountant, Klondike, is ill and will not be able to compute Lucky-7's net earnings by the due date of Lucky-7's return; therefore, he files for an extension on behalf of the partnership and each of the partners. On June 27,

³ DOL Reg. Section 2510.3-102(f)(2). IRC § 408(p)(1)(A), 408(p)(5)(A)(i). The IRC requires that elective contributions to a Simple IRA be deposited not later than the close of the 30-day period following the last day of the month with respect to which the contribution was made.

⁴ DOL Reg. Section 2510.3-102(e).

⁵ See example, VFCP Section 5, 67 Fed. Reg. 60 (March 28, 2002).

⁶ See, *Golden v. wwwrrr, Inc.*, 2002 U.S. Dist. LEXIS 3053 (D. Minn. 2002). For a copy, see <http://www.nysd.uscourts.gov/courtweb/Pdf/D08MNXC/02-01788.PDF#xml>. For a discussion of this case, see, S. Derrin Watson, "Plan Assets Go wwwrrr," 9 *Journal of Pension Benefits* 4 (Panel/Aspen, NY 2002). See *McConnell v. Costigan*, 2002 WL 313528 (S.D.N.Y. Feb., 28, 2002) regarding damages (some contributions were up to 600 days late).

Klondike notifies the partnership that it indeed had a profit, and that each of the partners is due an additional \$37,000. Lucky-7 must deposit \$91,000 (\$13,000 x 7) as contributions to the 401(k) plan of its seven partners as soon as the amounts can reasonably be segregated from the partnership's general assets, but no later than 15 business days after the end of June. For deduction purposes, the amounts must be deposited by July 15, 2005, the extended due date of Lucky-7's 2004 return.

Although very little guidance has been issued on this subject, the IRS has ruled that a partnership making periodic advances of earnings to each partner throughout the plan year (designed to be equivalent to periodic payments of compensation to each partner as if such partner were a common-law employee) could be contributed as elective contributions under a 401(k) plan, in which the partnership intended to withhold an amount from each partner's periodic advances pursuant to a deferral election.⁷

In most cases, participant contributions will become plan assets well in advance of the 15-day (30-day if SIMPLE IRA) outside deadline. With most payroll systems, employers are able to segregate wage-withholding amounts in a matter of days, if not almost immediately.

Ten-Day Extensions

An employer may extend the outside deadline under limited circumstances. With respect to participant contributions withheld by an employer in a single month, the outside deadline may be extended for ten additional business days, provided that within five business days after the end of the extended period, the employer provides written notice to participants stating:

1. That the employer elected to take such extension for that month.
2. That the affected contributions have been transmitted to the plan.
3. With particularity, the reasons why the employer could not reasonably segregate the participant contributions within the normal time-frame.⁸

The notice must be distributed in a manner reasonably designed to reach all the plan participants within five business days after the end of such extension period.

In addition, prior to the beginning of the extended period, the employer must obtain a performance bond or irrevocable letter of credit in favor of the plan and in an amount not less than the total amount of the participant contributions withheld by the employer in the previous month. The bond or letter must be guaranteed by a bank or similar institution that is supervised by the

⁷ IRS Ltr. Rul. 200247052 (Aug 28, 2002).

⁸ DOL Reg. Section 2510.3-102(d)(1).

federal government or a state government and must remain in effect for three months after the month in which the extension period expires.⁹

Within five business days after the end of such extension period, a copy of the notice must also be provided to the secretary of labor, along with a certification that the notice was provided to the participants and that the bond or letter of credit was obtained.¹⁰

Limitation on Extensions

An employer cannot elect the 10-day extension more than twice a year unless the employer pays to the plan an amount representing interest on the participant contributions affected by the extension.¹¹

Deposit Deadlines for Nonelective Employee Contributions

Nonelective employee contributions must be deposited as soon as they can reasonably be segregated from the employer's general assets, but in no event later than the fifteenth *business day* of the month following the month in which the participant contributions amounts are recorded.¹²

Deposit Deadlines for Loan Repayments

The DOL takes the position that untimely remittance of loan repayments is a prohibited transaction and occurs when loan repayments are made later than would be permitted under the participant contribution regulation.¹³

[I]t is the DOL's opinion that participant loan repayments, made to the employer for purposes of transmittal to the plan or withheld from employee wages by the employer for transmittal to the plan, become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

The DOL also said that, although the maximum periods for depositing participant contributions (i.e., the period ending with the fifteenth business day of the month following the month in which such contributions are received or withheld from wages) do not directly govern the repayment of participant loans, the DOL believes

that holding participant loan repayments beyond such periods would raise serious questions as to whether the employer forwarded the re-

⁹ DOL Reg. Section 2510.3-102(d)(2).

¹⁰ DOL Reg. Section 2510.3-102(d)(1).

¹¹ DOL Reg. Section 2510.3-102(d)(3).

¹² DOL Reg. Section 2510.3-102(b)(1)].

¹³ DOL Reg. Section 2510.3-102.

payments to the plan as soon as they were reasonably segregable from its general assets.¹⁴

Employer Contribution Deadline

The deadline for depositing employer contributions and employer matching contributions into the plan's trust is determined first by looking to the plan document, which may include deadlines as a matter of plan design. If the plan document merely requires that employer contributions be made by the date required by law, as many plans do, then the deadline will be determined under IRC Section 404(a) regarding the contribution deadlines for deductibility. Under IRC Section 404(a), an employer generally must make its contribution before the due date of the employer's tax return (including extensions). These same rules generally apply to employer matching contributions attributable to deferrals made during the plan year, although most employers make their matching contributions much sooner than required by IRC Section 404(a). Often, matching contributions are calculated on a payroll-by-payroll basis and must be deposited sooner by plan design. These rules are in sharp contrast to the rule that requires elective deferrals to be deposited to the plan's trust as soon as they reasonably can be segregated from the employer's general assets.¹⁵

Form 5500 Series Treatment of Late Deposits

Revised Form 5500 Series¹⁶ instructions for 2003 require plan auditors to review deposits of participant contributions (e.g., elective deferrals) and to confirm that the employer has deposited the contributions timely.

One of the methods the DOL uses to regulate this requirement is the Form 5500. Question 4a on Financial Information Schedules H and I (small plan) inquires as to whether the employer has failed to deposit participant contributions in accordance with the time period prescribed by the regulations; i.e., the earliest date the employer can reasonably segregate the contributions from its general assets, but in no event later than the fifteenth business day of the month following the month in which the employer withheld the contributions from employee's paycheck.¹⁷

¹⁴ DOL Adv. Op. 2002-02A (May 17, 2002) For a copy, see <http://www.dol.gov/ebsa/programs/ori/advisory2002/2002-02a.htm>.

¹⁵ IRC Section 404(a)(6).

¹⁶ Form 5500, Annual Return/Report of Employee Benefit Plan. Plan administrators annually file this report containing information described in section 103 of ERISA. Also known as EBSA Form 1210-0110. See www.dol.gov/library/forms/go-us-dol-form.asp?FormNumber=250&OMBNumber=1210-0110.

¹⁷ Prior versions of Schedules H and I address whether the employer had deposited the contributions within the maximum time period permitted in the regulations. To eliminate confusion, the DOL removed the word *maximum* from question 4a, beginning in 2002. The previous language erroneously suggested that employers have until the fifteenth business day of the following month to deposit the participant contributions, even if the contributions could have been segregated sooner.

Auditor's Confirmation

The 2003 Schedule H and I instructions now require a plan auditor to confirm the accuracy of the employer's response to question 4a. If an employer answers question 4a with a *no*, the plan auditor must determine whether the employer has responded to the question on line 4a in accordance with the regulations. In other words, the auditor will need to review the deposits to determine whether the deposits were in fact made timely. The auditor then must disclose on the audit report his or her determination in accordance with generally accepted auditing standards.

Obviously, if the auditor's opinion does not agree with the response in line 4a, the preparer either must change its response or anticipate a DOL investigation.

Small plans that qualify for the audit waiver under line 4k do not have to be concerned with the plan auditor review, but must nonetheless respond truthfully.

Prohibited Transaction Implications

The DOL no longer requires an employer to report late deposits of participant contributions as prohibited transactions on line 4d of Schedules H and I, and Schedule G (financial transaction information for large plans). Apparently, the DOL feels that reporting the late deposits on line 4a is sufficient. Although an employer no longer reports the late deposits as a prohibited transaction on Schedule G, the employer still must correct the prohibited transaction and file Form 5330 to pay the excise tax. For large plans (and small plans which are ineligible for the audit waiver), the DOL continues to require the auditor's opinion to cover the delinquent participant contributions.

If an employer corrects the late deposit of participant contributions by filing under the VFCP, discussed in Chapter 12, the employer does not have to pay the prohibited transaction excise tax. Even if the employer qualifies for the excise tax exemption, the employer must report the late deposit on question 4a (i.e., answering question 4a with a *yes*).

Compared to the cost of preparing and submitting an application under the VFCP, most employers will pay the excise tax and correct the deficiency using the methodology of the VFCP without filing under the program. To address the *yes* response in question 4a, the preparer should include a footnote to Schedule H or, as applicable, to notify the DOL that full correction utilizing the methodology provided under the VFCP program has taken place.

Chapter 20

Beneficiary Designations

BY PETER J. GULIA, ESQ.

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Beneficiary Designations

By PETER J. GULIA, ESQ.

A participant's use of his or her valuable right under a retirement plan to name a beneficiary is an important part of estate planning. Because a retirement benefit is not transferred by a will, a beneficiary designation affects a person's overall estate plan. This chapter explains some of the rules for making a beneficiary designation, including marriage and family rights that can restrain a beneficiary designation.

Many people mistakenly assume that they lack enough wealth for estate tax issues to be of concern, even when one or more estate, inheritance, or other transfer taxes likely will apply. This chapter, therefore, discusses a few simple tax-oriented estate-planning concepts.

The chapter includes an explanation of how CPAs may advise clients about beneficiary designations, and concludes with a top-ten list of common mistakes that CPAs can help clients avoid.¹

CPA Practices

In addition to the basics of beneficiary designations, a CPA should be aware of the following:

- If a CPA's consulting engagements include estate planning, he or she must understand beneficiary designations to render competent tax advice.²

¹ *Author's Note.* Given federal and state laws that prohibit or otherwise preclude a person who is not a lawyer from giving legal advice, this chapter assumes that a CPA who is not a lawyer must sometimes refrain from giving advice, even when a CPA might be competent to render advice. A CPA should present any suggestions carefully, and in a manner that follows certified public accountants' rules and standards.

² Statement on Standards for Tax Services No. 8, *Form and Content of Advice to Taxpayers* (AICPA, Professional Publications, vol. 2, TS sec. 800).

- If a CPA performs personal financial planning engagements, he or she must understand beneficiary designations to render competent advice about how a client may use his or her resources to meet his or her financial goals.³
- Even a practitioner who does not perform personal financial planning can help clients spot common mistakes in making beneficiary designations, discussed later. This practical advice might earn clients' respect and loyalty.
- If a CPA performs audit, review, or controls testing engagements for retirement plans, he or she needs to be ready to examine and advise clients about how to design prudent procedures for collecting and checking beneficiary designations.⁴

Even if a CPA does not perform any of these practices, he or she might prefer to maintain general awareness of laws concerning beneficiary designations because, far more than probate transfers, beneficiary designations are the primary means most Americans use to pass wealth.

Many of the explanations in this chapter will make better sense to the reader if he or she keeps in mind a few general principles and some special language of retirement plans.

ERISA Preemption

Most employment-based retirement plans are governed by the Federal Employee Retirement Income Security Act of 1974, as amended (ERISA).⁵ ERISA federalizes the law of employee-benefit plans. For a larger employer that has employees and former employees who live in many states, it would be burdensome to apply many different state laws. Even for a smaller employer that has employees and former employees concentrated in only a few states or even one state, it might be difficult to administer a plan following state laws. So, ERISA preempts state laws.⁶

The ERISA preemption rule is one of the fundamentals of the law of retirement plans. A reader will notice that almost every rule or explanation concerning beneficiary designations under a retirement plan has two different answers. For an ERISA plan (as defined below), only ERISA and the plan's documents apply.⁷ For a non-ERISA plan, one or more states' laws might apply.

³ See generally, American Institute of Certified Public Accountants, Code of Professional Conduct, Rule 201, *General Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 201.01), and accompanying Interpretations.

⁴ AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 9.02b (2004).

⁵ The nontax provisions of ERISA are codified as 29 U.S.C. Sections 1001-1041. Because most publications used by employee-benefits practitioners cite ERISA's Act sections, this chapter's citations are to the Act sections.

⁶ ERISA preempts state laws that relate to an employee-benefit plan. ERISA Section 514(a). An exception recognizes laws that regulate banking, insurance, or securities. ERISA Section 514(b)(2). ERISA does not preempt "any generally applicable criminal law of a State." ERISA Section 514(b)(4).

⁷ Along with ERISA's preemption of state laws, ERISA Section 404(a)(1)(D) requires that an employer administer the plan according to the plan's documents.

ERISA or State Law

Many rules for beneficiary designations are common to all kinds of retirement plans. For some of the rules that are not common to all kinds of retirement plans, this chapter explains the difference. Also, this chapter explains the differences between ERISA, which governs most employment-based retirement plans, and state law, which governs most IRAs. State law also governs church plans and governmental plans, but because this book is about retirement plans for smaller businesses, this chapter does not focus on plans sponsored by charity, church, and governmental employers. For a reader's convenience, in each topic this chapter explains first the rule for ERISA plans, and then explains state law.

Definitions

For the reader's convenience, this chapter uses certain shorthand terminology for some terms of art. The author hopes this usage will make sense in context. Because the chapter covers many different kinds of retirement plans, readers will be better prepared to understand this information if they first refer to the definitions that follow:

- *ERISA plan* refers to a *retirement plan* (see below) that is governed by the federal law, namely, ERISA.
- *Non-ERISA plan* refers to a retirement plan (including an IRA) that is not an ERISA plan.
- *Nonprobate* refers to property that is transferred or contract rights that are provided without a probate administration, which is defined below.
- *Participant* refers to a participant (rather than a beneficiary or alternate payee) under a retirement plan, or the original owner of an individual retirement account or annuity (IRA).
- *Payor* refers to any trustee, custodian, bank, broker-dealer, insurer, plan administrator, or other person responsible to decide or pay a claim under or regarding a retirement plan.
- *Probate* refers to property that is transferred through a court-supervised administration or succession.
- *Retirement plan* or *plan* refers to a plan or arrangement that is one of the following:
 - Qualified plan under Internal Revenue Code (IRC) Section 401(a)
 - Cash or deferred arrangement under IRC Section 401(k)
 - Individual retirement account under IRC Section 408(a)
 - Individual retirement annuity under IRC Section 408(b)
 - Simplified employee pension plan (SEP) under IRC Section 408(k)

- Salary-reduction SEP (SARSEP) under IRC Section 408(k)(6)
- Savings incentive match plan for employees (SIMPLE) under IRC Section 408(p)

Except for differences between ERISA and state law (explained below), beneficiary-designation rules apply in a similar manner to these different retirement plans.

- *State.* This chapter uses the word *state* in its popular meaning to refer to the District of Columbia or any state, commonwealth, territory, possession, or similar jurisdiction within the United States of America. Because this chapter has many references to state law, this chapter uses only the word *state* (rather than the legal term, which is *jurisdiction*) for reading ease. For example, although the District of Columbia is not a state, law that applies to a person because he or she resides in the District is state law, as distinguished from United States law or federal law that applies throughout the United States of America.

About Beneficiary Designations

A retirement plan includes a provision by which a participant may name his or her beneficiary or beneficiaries. The beneficiary designation applies, even if the participant's will states a contrary disposition. Although that outcome results simply from applying the terms of a plan, some states for convenience include an explicit provision in the probate statute. Also, courts have held that a will may not override a beneficiary designation.

- *ERISA.* For an ERISA plan, only the plan's provisions govern a beneficiary designation.
- *State Law.* For a non-ERISA plan, state law may supplement a plan's provisions concerning the manner of making a beneficiary designation. For example, New York law requires that a beneficiary designation be signed.

Using Trusts

A participant may not hold his or her retirement benefit in a living trust.⁸ A retirement plan provides that a participant may not assign or transfer any right he or she has under the plan. Because its maker may revoke or change a living trust, the trust declaration or agreement could not assure that during the participant's lifetime the retirement benefit must be used only for the participant's benefit.

⁸ A living trust (also called an *inter vivos* trust) is a trust established and in effect during the lifetime of the grantor; as opposed to a testamentary trust, which takes effect upon the death of the grantor. A living trust can be revocable or irrevocable (but the kind of living trust that many people use as a partial substitute for a will is usually revocable).

Moreover, there is no need to put a retirement benefit into a living trust. A retirement plan benefit is nonprobate property that will pass according to the plan's beneficiary designation.

A participant may name a trust as beneficiary under a retirement plan. To make a correct beneficiary designation, the participant should name the trustee, as trustee of the trust, as beneficiary. The trust must be legally in existence (or completed such that it would be legally in existence on the trustee's receipt of money or property) before the participant makes the beneficiary designation.

Practice Pointer: A beneficiary of a trust will not be a designated beneficiary under a retirement plan's minimum required distribution (MRD) rules unless the trust meets conditions and certifies to the plan administrator (if any) information specified in the federal tax regulations.

Making a Beneficiary Designation

Ordinarily, only a participant may make a beneficiary designation.

A plan may permit a beneficiary to name a further contingent beneficiary if the participant had not (before his or her death) designated all of the benefit and the plan lacked any other default provision (see below).⁹ Such a provision can cause the benefit that remains undistributed at each beneficiary's death to be subject to federal estate tax (and state inheritance tax), notwithstanding that the same benefit was previously so taxed on the participant's (and earlier beneficiaries') death.¹⁰ A federal estate tax may be postponed if a beneficiary names his or her spouse as the succeeding beneficiary and that spouse has the power (legal right) to take the entire remaining benefit.¹¹

Practice Pointer: A careful participant will make a complete beneficiary designation that contemplates all possibilities. If a participant does not want to specify alternate takers, he or she could create a trust, which could include a power of appointment for a beneficiary to name a further beneficiary.¹²

⁹ See Ltr. Rul. 199936052 (June 16, 1999), concerning an IRA.

¹⁰ IRC Section 2041(a)(2); Treas. Reg. Section 20.2041-1(b).

¹¹ IRC Section 2056; Ltr. Rul. 199936052 (June 16, 1999).

¹² If a participant who creates such a trust has a spouse, he or she might consider whether the trust might, in some circumstances, provide a benefit for the spouse, and (if so) whether it is desirable for the trust's provisions to preserve one or more ways to obtain the federal estate tax marital deduction. Treasury Regulations Section 20.2056(b)-5(f)(6) provides that, concerning a trust that was created during the decedent's life, it does not matter whether the trust provided the participant's spouse a power of appointment before the participant's death. Further, this regulation provides that if a trust may be ended during the life of the surviving spouse by his or her exercise of a power of appointment or a distribution of the corpus to him or her, an interest passing in trust meets the condition that the spouse must be entitled to all income from the marital-deduction property if the spouse is entitled to the income until the trust ends, or has the right, exercisable in all events, to have the corpus distributed to him or her at any time during his or her life. See also Ltr. Rul. 199936052 (June 16, 1999).

ERISA

A retirement plan administrator may accept a beneficiary designation made by a participant's agent under a power of attorney, but is not required to do so. Typically, a plan administrator will decline to act unless the power-of-attorney document expressly states a power to change beneficiary designations.

State Law

An IRA payor may (and sometimes must) accept a beneficiary designation made by an agent under a power of attorney. For an IRA, state law governs whether a payor may or must permit the actions of an agent under a power of attorney.

Caution: *An IRA might provide that the participant cannot act by an agent.*

In some states, banking law regulates how a bank or trust company must evaluate whether to honor a power of attorney.

Substantial-Compliance Doctrine

When recognized, the doctrine of substantial compliance might excuse a participant's failure to effect a change of beneficiary according to a plan's terms if he or she intended to change his or her beneficiary and did everything reasonably in his or her power to effect the change. Courts find that this equitable doctrine of substantial compliance circumvents "a formalistic, overly technical adherence to the exact words of the change of beneficiary provision in a given [contract]."

A payor's interpleader (or other circumstances that make a payor a mere stakeholder) does not change the burden of proof; a claimant must show the participant's substantial compliance with the plan's procedure for making a beneficiary designation.

Practice Pointer: To avoid this problem, altogether, CPAs should ask their clients about beneficiary designations at each personal financial-planning review.

ERISA

For an ERISA plan, the doctrine of substantial compliance should apply only if the plan administrator in its discretion decides to use such a concept to aid its own interpretation or administration of the plan.

Concerning an ERISA plan, a court should hold that ERISA preempts a state's doctrine of substantial compliance. However, some federal courts have held that a state's common-law doctrine of substantial compliance supplements an ERISA plan's provisions. In the absence of findings by the plan administrator, a federal court found that a state's doctrine of substantial compliance may be replaced by a federal common-law doctrine of substantial compliance. Although some federal courts considering the question have held that ERISA does not necessarily preempt a state's doctrine of substantial compli-

ance, that view is incorrect. Still, a CPA must be aware that federal courts often render wrong decisions.

Unless a plan provision is contrary to ERISA, an ERISA plan administrator should administer a plan according to the plan's documents.¹³ Therefore, if a plan states that any doctrine of substantial compliance will not apply, the plan administrator must interpret and administer the plan without using such a doctrine.

Practice Pointer: Some plan documents say that the doctrine of substantial compliance will not apply. So, it is important for a CPA to urge a client to pay attention to his or her beneficiary designations.

Further, if a plan grants the plan administrator discretion in interpreting or administering the plan, a court will not interfere with the plan administrator's decision unless it was an abuse of discretion.

State Law

For a non-ERISA plan, a state court likely would apply the state's doctrine of substantial compliance. Therefore, the doctrine of substantial compliance usually applies to a defective beneficiary designation for an IRA not held under an ERISA plan.

Default Beneficiary Designation

A plan usually will provide for a default beneficiary designation that applies when the participant has not made a valid beneficiary designation. A typical provision pays the nondesignated benefit to the executor of the participant's probate estate.

Practice Pointer: Do not let a client's family suffer the inconvenience of requiring an administrator to figure out a plan's default provision. Instead, remind clients to make and keep up-to-date their beneficiary designations.

If a participant's estate closed before a plan's payment occurs, a court may reopen the estate for subsequent administration on the discovery of property that was not disposed by the previous administration.

If, applying community-property law (see below), a portion of a participant's benefit belongs or belonged to the participant's spouse, the spouse (or the spouse's beneficiaries or heirs) might have a claim against the participant's executor for payment of the spouse's community property. Also, in Colorado, Hawaii, Kentucky, Michigan, and Oregon, the Uniform Disposition of Community Property Rights at Death Act might apply.

¹³ ERISA Section 404(a).

Lost Beneficiary Designation

If a plan administrator cannot locate a beneficiary designation because the plan's records were destroyed, the plan administrator should try to "reconstruct" the beneficiary designation using the best evidence available to it.

That records are lost or destroyed does not discharge a plan administrator from its duty to administer the plan. When deciding whether to pay any benefit to a potential beneficiary, a plan administrator must act in good faith and must use reasonable procedures, especially when deciding who is a participant's beneficiary. When a record is lost or destroyed, a plan administrator may use the most reliable evidence available to it. For example, a service provider might have a copy of a beneficiary designation. Or a claimant might furnish a copy of a beneficiary designation. A plan administrator might use its discretion to rely on a document that appears to be a copy of a participant's beneficiary designation. But a plan administrator should do so only if it has adopted and uses reasonable procedures designed to detect a forgery. Further, when a claimant submits evidence that he or she is the participant's beneficiary, a plan administrator must take reasonable steps to consider whether the evidence is credible.

Practice Pointer: A CPA should suggest to a client that he or she give a copy of a designation to the beneficiary.

Laws and External Documents That Might Affect a Beneficiary Designation

A retirement plan's beneficiary regime should be designed to minimize the situations in which a plan administrator or payor should need to consider anything beyond the plan's provisions and the beneficiary designation filed with the plan administrator. However, sometimes it is impossible to avoid the demands of other laws.

Divorce as Revocation of a Beneficiary Designation

Whether a divorce revokes a beneficiary designation turns on whether ERISA or state law governs the retirement plan.

State Law

For a non-ERISA plan, state law might apply. In many states, a divorce will not revoke a beneficiary designation that names the ex-spouse. In other states, a statute might provide that a divorce or annulment has the effect of making a former spouse not a beneficiary, except as otherwise provided by a court order. Even when the relevant state has such a statute, it might not apply if the plan has contrary provisions, and many plans include a provision that a divorce or anything other than the plan's beneficiary-designation form has no effect on the beneficiary designation. Further, the law of the state in which a participant resided when he or she died is not necessarily the governing law.

Practice Pointer: Many investment managers are based in Boston or New York; many securities broker-dealers prefer New York law, and many trust companies prefer Delaware law. Because an IRA usually is a printed-form contract offered by its custodian, Delaware, Massachusetts, or New York law often is an IRA's governing law. If the law of one of those states applies, a divorce does not revoke a beneficiary designation of a former spouse.

In any case, state law will protect a payor that pays the beneficiary of record unless the payor has received a court order restraining payment or at least a written notice that states a dispute about who is the lawful beneficiary.

ERISA

For an ERISA plan, ERISA preempts state laws. Therefore, only a plan's terms will govern whether a divorce or other circumstance has any effect on the plan beneficiary designation.

A qualified domestic-relations order (QDRO) does not preclude a participant from continuing a beneficiary designation that provides for his or her former spouse.

Practice Pointer: A CPA might remind his or her client, after a divorce, to change or confirm the client's beneficiary designations.

Beneficiary Designation Contrary to an External Agreement

A plan administrator pays according to the plan's provisions, and need not consider external documents.

ERISA

For an ERISA plan, ERISA preempts state laws that otherwise might affect who gets a plan benefit.

State Law

For a non-ERISA plan, a plan administrator also pays according to the plan's provisions, and ordinarily need not consider external documents (other than a court order that applies to the administrator). However, once a non-ERISA plan has paid the plan beneficiary, a person who has rights under an external agreement may pursue remedies under state law.

Executors

An executor often may not participate in a court proceeding concerning a disputed benefit. A personal representative of a participant's estate may participate in a court proceeding concerning a disputed benefit only if the personal representative is a bona fide claimant. But if a personal representative does not make any claim of right to the benefit, such a personal representative has no claim that a court will consider and thus no standing to participate in a court proceeding.

When a Beneficiary Is a Minor

A divorced person might not want to name his or her young child as a beneficiary if doing so might have the effect of putting money in the hands of the child's other parent, namely, the participant's former spouse.

A payor wants to be sure that a payment is a complete satisfaction of the contract. Ordinarily, a beneficiary's deposit or negotiation of a check is the beneficiary's acceptance of the satisfaction of the beneficiary's claim.

A minor is a person still young enough that he or she cannot make a binding contract. While state laws vary, most end a person's minor status at age 18. Usually, a minor's emancipation from his or her parents does not change the minor's lack of power to make binding contracts.

Before a child reaches age 18 (or the other age of competence to make binding contracts), his or her guardian or conservator may disaffirm an agreement or promise the child made. After a child reaches age 18 (or the other legal full age), he or she may disaffirm an agreement or promise he or she made before he or she reached the age of competence to make contracts.

If state law applies, a payor will not take the risk that a payment is not a complete satisfaction of plan obligations. Even if ERISA preempts state law, a plan administrator might be concerned that a court would fashion a federal common-law rule. Thus, plan administrators, employers, and payors almost universally are unwilling to pay benefits to a minor.

To facilitate payment in these circumstances, most retirement plans permit payment to a minor's conservator, guardian, or Uniform Transfers to Minors Act custodian. If a participant named his or her child as a beneficiary (rather than naming as beneficiary a custodian), a plan administrator or payor is likely to honor a claim made by the child's guardian. If a child's other parent is living, most courts would appoint the parent as the child's conservator. In some states, the law presumes that a parent is a child's natural guardian and conservator.

Practice Pointer: If a person does not want his or her child's other parent to get the child's money, suggest that such a participant name a custodian as his or her beneficiary.

Family Rights That Restrain a Beneficiary Designation**Failing to Provide for a Spouse*****ERISA***

Under an ERISA plan, a participant's beneficiary designation that fails to provide for his or her spouse will be invalid, for either 100 percent of the death benefit or the value of the plan's qualified preretirement survivor annuity

(QPSA), whichever is provided by the plan, unless the participant made a qualified election that was supported by the spouse's notarized consent.¹⁴

State Law

If a non-ERISA plan does not require a spouse's consent, a plan administrator or payor will, in the absence of any court order or written notice of a dispute, give effect to the participant's beneficiary designation. Even when a participant's beneficiary change has an obvious potential to frustrate a divorcing spouse's equitable-distribution rights, a participant remains free to make his or her beneficiary designation unless a court's restraining order binds him or her. Further, an order that binds a participant might not bind a plan or its administrator.

If a participant's surviving spouse did not receive his or her elective share (see below) provided by state law, a distributee is liable to the participant's executor or spouse if state law provides for a spouse's elective share to be payable from nonprobate property.

If a participant's surviving spouse did not receive his or her community-property share (see below) provided by state law, a distributee is liable to the participant's executor or spouse.

Practice Pointer: If a distributee received a plan distribution in one year but paid over an amount to the participant's surviving spouse in a later year, the distributee recognizes income for the year he or she received the distribution and claims a deduction for the year he or she paid restoration to the surviving spouse.

Caution: *A surviving spouse who is not the participant's named beneficiary and instead receives a retirement benefit because of an elective-share or community-property law is not a designated beneficiary when applying the plan's minimum-distribution provisions. Thus, it might become necessary to compute a minimum distribution by reference to a different person's life.*

In Louisiana, a plan administrator may follow the participant's beneficiary designation. However, a distributee who receives benefits under an IRA or another non-ERISA plan must account for and pay over benefits to the participant's surviving spouse if payment is necessary to satisfy the spouse's community-property rights and usufruct. A distributee who receives benefits under a retirement plan of "any public or governmental employer" is not subject to the claims of forced heirs.

Different law may apply for members of a Native American Indian tribe. However, a Native American Indian tribe's law usually applies between or among members of the tribe, and often cannot be enforced against a person outside the tribe.

¹⁴ ERISA Section 205.

Usually, a plan administrator need not tell an ex-spouse when a participant changes his or her beneficiary designation, even if a participant violates a court order in doing so. In the absence of a court order that commands the plan administrator to furnish specified information, a plan administrator has no duty to furnish information about a particular beneficiary-designation change.

Failing to Provide for a Child

Under either an ERISA plan or a non-ERISA plan, a participant almost always is not required to provide for his or her child.

ERISA

Unless a plan states its own provisions, nothing in ERISA requires a participant to name his or her child as a beneficiary. ERISA preempts state laws concerning an ERISA plan's retirement benefits.

State Law

A participant may make a beneficiary designation that does not provide for his or her child. In the United States, only Louisiana and Puerto Rico have a forced-share provision for a decedent's children. Therefore, a person usually may "disinherit" his or her children. In some states, a modest family allowance (typically \$10,000) is required for a decedent's children if there is no surviving spouse.

In Louisiana, a plan administrator may follow the participant's beneficiary designation. But a distributee who receives benefits under an IRA or other non-ERISA plan must account for and pay over benefits to the participant's surviving spouse if payment is necessary to satisfy the spouse's community-property rights and usufruct and to the participant's children or forced heirs if payment is necessary to satisfy their required portions.¹⁵

Practice Pointer: If a client resides in a nation other than the United States and wants to make a beneficiary designation that does not provide for his or her spouse and children, a CPA should urge the client to get an expert lawyer's advice.

Spouse's Rights

A participant's surviving spouse might have rights to a participant's retirement benefit in one of the following ways:

- Survivor-annuity or spouse's consent rights provided by the plan
- Elective-share rights under state law (see below)
- Community-property rights under state law (see below).

¹⁵ See *Eskine v. Eskine*, 518 So. 2d 505, 508 (La. 1988).

ERISA Survivor Benefits or Spouse's Consent Rights

An ERISA plan must provide some kind of benefit to a participant's spouse. The form of the required benefit turns on whether a distribution begins because of the participant's retirement or death.

For a distribution that begins before a participant's death, a plan must, unless an exception applies, provide a qualified joint and survivor annuity.¹⁶

Ordinarily, a defined-contribution plan that is not governed by ERISA funding standards need not provide a qualified joint and survivor annuity (QJSA) as long as a participant does not elect that his or her retirement benefit be paid as a life annuity.¹⁷

If a plan provides a life annuity as a normal form of benefit, a plan sponsor may amend the plan to provide that every annuity is an optional form of benefit, or to eliminate every annuity option. Such an amendment is not a cutback of accrued benefits.¹⁸ Once the amendment is effective, the plan need not provide a QJSA unless (if the plan permits) a participant affirmatively chooses it or chooses a different life annuity and fails to deliver a qualified election.

Practice Pointer: A CPA should thoroughly consider all significant tax treatments before suggesting that a participant choose a single sum or other short-term payout. In some states, only a life annuity or periodic payments similar to a life annuity will qualify for favorable treatment as a pension under state income tax laws.

For a distribution that begins after a participant's death, a plan must provide a qualified pre-retirement survivor annuity or an alternate survivor benefit.¹⁹

Qualified Joint and Survivor Annuity

A qualified joint and survivor annuity is an annuity for the participant's life, with a survivor annuity for the surviving spouse's life. The periodic payment of the survivor annuity must be no less than 50 percent (and no more than 100 percent) of the payment during the joint lives of the participant and spouse. A qualified joint and survivor annuity is the actuarial equivalent of an annuity on only the participant's life.²⁰

¹⁶ ERISA Section 205(a)(1), 205(b).

¹⁷ ERISA Section 205(b)(1)(C)(ii).

¹⁸ ERISA Section 204(g)(2)(B); Treas. Reg. Section 1.411(d)-4, Q&A-2(e). For this and other ERISA vesting rules, a federal government reorganization plan provides that the secretary of the treasury, rather than the secretary of labor, makes rules to interpret both ERISA's and the IRC's provisions.

¹⁹ ERISA Section 205(a)(2), 205(b).

²⁰ ERISA Section 205(d).

Qualified Preretirement Survivor Annuity

For a defined-contribution plan, a qualified preretirement survivor annuity is the annuity that results from using no less than half the participant's vested account balance to buy an annuity for the surviving spouse's life.²¹

Alternative Survivor Benefit

For a defined-contribution plan that is not governed by ERISA funding standards, a plan may omit both a qualified joint and survivor annuity and a qualified preretirement survivor annuity if the plan (in addition to meeting other conditions) provides that, absent a qualified election, the benefit that remains after a participant's death belongs to the participant's surviving spouse.²²

Qualified Election

An ERISA plan must include a provision that assures a participant's surviving spouse some retirement income after the participant's death, and must include a provision that assures a survivor benefit if the participant dies before he or she receives or begins a distribution.²³ A plan must permit a participant to "waive" one or more of these benefits.²⁴ To do so, a participant must deliver to the plan administrator a qualified election.²⁵ Ordinarily, such an election has no effect unless the participant's spouse consents to the election.²⁶ Also, a participant's qualified election must meet several form, content, and procedure requirements.

Spouse's Consent

An election is a qualified election only if the participant's spouse consents to it. In addition to meeting other form, content, and procedure requirements, a spouse's consent to a participant's election must:

- Be in writing;
- Name a beneficiary that cannot be changed without the spouse's consent, or expressly consent to the participant's beneficiary designations (without further consent); and
- "Acknowledge" the effect of the participant's election.²⁷

Further, a consent has no effect unless "the spouse's consent is witnessed by a plan representative or a notary public[.]"²⁸ Courts have held that there must be strict compliance with these requirements.

²¹ ERISA Section 205(e)(2).

²² ERISA Section 205(b)(1)(C).

²³ ERISA Section 205.

²⁴ ERISA Section 205(c)(1)(A).

²⁵ ERISA Section 205(c)(2).

²⁶ ERISA Section 205(c)(2)(A).

²⁷ ERISA Section 205(c)(2)(A)(i).

²⁸ ERISA Section 205(c)(2)(A)(iii).

A spouse's guardian may sign the spouse's consent, even if the electing participant is the spouse's guardian.²⁹ However, a guardian must act in the best interests of his or her ward. A guardian serves under a court's supervision, and must account for his or her actions in court. Further, some guardianship decisions require a court's approval before the guardian implements the decision. It might be difficult to persuade a court that turning away money was in a surviving spouse's best interest. Although a participant might suggest making an irrevocable designation naming a trust for his or her spouse's benefit as the plan beneficiary, most retirement plans do not permit an irrevocable beneficiary designation.

A premarital agreement cannot serve as a spouse's consent. (See below.)

Notary or Plan Representative

ERISA does not define its use of the words "notary public" or "plan representative."³⁰ The Retirement Equity Act of 1984's legislative history does not explain what Congress meant.

A person might be a plan representative for the limited purpose of administering a plan's provisions required or permitted by ERISA's spouse's consent rule if the plan administrator has authorized the person to witness a spouse's consent.

In a case that involved facts and forms typical of a retirement plan's service arrangements, a federal court found that the litigants who asserted that a spouse's consent had been witnessed did not offer enough evidence even to allege that a securities broker-dealer's employee was a plan representative.

Practice Pointer: If a CPA currently provides (or later might provide) services that require the CPA to be independent of the retirement plan or its administrator, the CPA should not witness a spouse's consent.³¹

Many plan administrators assume that a person who may certify acknowledgments, affidavits, and other oaths under federal or state law is a notary.

If a person is not present in the United States, his or her acknowledgment may be made before a United States ambassador, consul, consular officer, or consular agent. A consular officer must officiate and perform a notarial act that an applicant properly requests. Likewise, federal law provides convenient ways for a person in military service to make an acknowledgment.

A notary must be independent of the participant. Although nothing in ERISA requires that a witness to a spouse's consent be independent of the electing participant, courts have interpreted the statute to include such a requirement. The federal courts' view is consistent with state laws concerning

²⁹ Treas. Reg. Section 1.401(a)-20/Q&A-27.

³⁰ ERISA Sections 3, 205.

³¹ American Institute of Certified Public Accountants, Principles of the Code of Professional Conduct Section 57 (2000).

when a notary properly may officiate and the legal effect of a notary's certificate that he or she witnessed an acknowledgment.

Likewise, a plan representative must be independent of the participant. A federal court found that a plan administrator who was the same person as the electing participant could not, even if he was a plan representative (or even the only plan representative), witness his spouse's consent.

Practice Pointer: If a participant wants to make a beneficiary designation that would provide for anyone other than his or her spouse and the participant also is a plan administrator, trustee, or other fiduciary, suggest that the client ask the spouse to sign the consent in the presence of an independent notary.

Because ERISA permits a plan administrator to rely on a spouse's consent witnessed by a notary, it seems unlikely that a federal court would find that it could be prudent for a plan administrator to rely on a spouse's consent witnessed only by the interested participant or someone who is subordinate to the interested participant.³²

Reliance on a Notary's Certificate

If a plan administrator acted according to ERISA's fiduciary duties when it decided whether to accept a spouse's consent, the consent, even if not properly witnessed, nonetheless discharges the plan from liability to the extent of the payments made before the plan administrator knew that the consent did not meet the plan's requirements.³³ If a plan administrator acted according to ERISA's fiduciary duties, it is not liable to the nonconsenting spouse.³⁴ Of course, the plan administrator must promptly correct or restrain payments once it knows that a spouse's consent was not properly witnessed.

If a plan might incur an expense because the plan administrator relied on a notary's certificate, the plan's fiduciary might be under a duty to evaluate whether it is in the plan's best interest to pursue a claim or lawsuit against the notary. A notary is responsible for damages caused by his or her negligent performance of his or her duties. Also, a spouse who did not receive what he or she would have been entitled to had the notary performed correctly may sue the notary.

³² ERISA Sections 205(c)(6), 404(a)(1).

³³ ERISA Section 205(c)(6).

³⁴ ERISA Section 404(a)(1).

Practice Pointer: Although generally accepted accounting principles require an accrual for a contingent liability, the accounting principle of conservatism often counsels against recording a contingent asset.³⁵ One example is Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, paragraphs 91-97. Accounting Principles Board Statement (APB) No. 4, states “The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events[,] and minimization of the amount of net assets and net income.” In paragraph 171, the Statement says, “[A]ccountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism[.]”. However, a gain contingency must be disclosed with a careful explanation.³⁶

Elective-Share Rights

In almost all states that do not provide community property, a decedent’s surviving spouse may elect to take a share of the decedent’s property, even if the decedent’s will and other transfers had not provided for his or her spouse.

In many states, a surviving spouse’s elective share is one-third of the decedent’s estate. In a few, it is one-half.

In Colorado, Hawaii, Kansas, Minnesota, North Dakota, South Dakota, Utah, and West Virginia, the elective-share percentage increases under a schedule based on the duration of the marriage. A typical schedule has an elective-share percentage that ranges from 3 percent for a marriage that lasted one year to 50 percent for a marriage of 15 years or more.

Some states compute an elective share only on probate property. But many states now provide that an elective share is computed on an “augmented estate” that includes several items of nonprobate property. Florida, New York, North Carolina, and Pennsylvania have detailed rules for counting this augmented estate.

Community Property

Community property is a term that lawyers use to refer to a regime that treats each item of property acquired by either spouse during a marriage and while both spouses are domiciled in a community-property state as owned

³⁵ Statement of Financial Accounting Standards No. 5, paragraph 17, published by the Financial Accounting Standards Board (FASB), 1975, states, “Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.” See also, *Contingencies*, Accounting Research Bulletin No. 50, paragraphs 3 and 5. See generally, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

³⁶ FASB Statement No. 5, *Accounting for Contingencies*, paragraph 17, published by the FASB, 1975, states, “Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.” See generally, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 97, published by FASB, 1980, states, “[T]he reliability of financial reporting may be enhanced by disclosing the nature and extent of the uncertainty surrounding events and transactions[.] . . . The aim must be to put the users of financial information in the best possible position to form their own opinion of the probable outcome of the events reported.”

equally by each spouse. Each spouse's ownership exists presently, notwithstanding that the other spouse currently holds title to or has control over the property. Generally, a retirement benefit is community property if contributions were made while the participant was married and domiciled in a community-property state.

In a separate-property regime, which normally applies in 41 states and all United States territories and possessions except Puerto Rico, an item of property normally belongs to the person who paid for it, earned it, or otherwise acquired it. Although property owned by a married person becomes subject to equitable distribution on a divorce or other marital dissolution, the property belongs completely to the person who owns it until a court makes an order that divides or distributes the property.

Community-Property States

Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Puerto Rico, Texas, Washington, and Wisconsin are the United States community-property states.

Alaska allows married people to choose a separate-property regime or a community-property regime. The separate-property regime applies unless the married couple agree to use a community-property regime. If the couple chooses community property, the spouses may use a written community-property agreement or trust to vary some of the state law provisions that otherwise would govern their community property.

Although community-property regimes in the USA are based primarily on the same general principle, community-property law varies considerably from state to state.³⁷ (Wisconsin is the only state that has adopted any form of the Uniform Marital Property Act.) For example, if all plan contributions were made before the participant was married but investment earnings accrued after the marriage, some states would classify all the retirement benefit (including investment earnings) as separate property, while others might classify those investment earnings that accrued after the marriage as community property.

Community-Property Law and Retirement Plan Benefits

Whether a state's community-property law could affect a retirement benefit turns on whether the retirement plan is an ERISA plan or a non-ERISA plan.

ERISA

ERISA preempts state laws that relate to an ERISA plan. In particular, the U.S. Supreme Court has held that ERISA preempts community-property laws that otherwise might affect a retirement plan benefit. Instead, ERISA provides its own rules designed to protect a surviving spouse or to require a plan administrator to follow a QDRO that divides a participant's benefit to provide a benefit for the participant's spouse or former spouse.

³⁷ The community-property concept is based on Spanish ganancial system, which controls the title and disposition of the property acquired during marriage by the husband or wife. See *Bouvier's Law Dictionary*, Revised Sixth Edition, 1856. http://www.constitution.org/bouv/bouvier_g.htm.

State Law

Concerning an IRA or other non-ERISA plan, if a participant names a beneficiary other than his or her spouse for more than half of (or, more precisely, the participant's separate property plus community-property rights in) his or her retirement benefit, the spouse might have a right under state law to seek a court order invalidating the beneficiary designation, or at least as much of it as would leave the spouse with less than half of, or the spouse's community-property rights in, the benefit.

However, a payor may make distributions based on the beneficiary designation it has on record until it receives a court order restraining payment or at least a written notice that the spouse asserts his or her rights.

Marriage

As explained above, an important restraint on a beneficiary designation is a spouse's rights. Of course, these rights turn on a spouse showing that he or she was a participant's spouse. Although many people are accustomed to marriage certificates, sometimes it is unclear whether a marriage existed.

This part explains some basics of marriage, and then explains differences between ceremonial marriage and informal or common-law marriage.

The Nature of Marriage

Marriage is a civil contract and a relation or status by which each of two persons agrees to live with the other as spouses, to the exclusion of others.

States regulate marriage as part of their police power. Most states recognize a marriage contracted in another state, unless the marriage is contrary to public policy.

Void Marriage

A void marriage is one that is invalid from its inception, and cannot be made valid.

A marriage is void if:

- The parties are too closely related, or
- Either party is (at the time of the ceremony or exchange of word) married to someone else.

In some states, a later marriage becomes valid on the end of an earlier marriage, if both parties to the later marriage were unaware that the earlier marriage was undissolved when they entered into the later marriage.

A marriage is void if the parties are of the same sex and a restriction against such a marriage is not unconstitutional.

Either party may “walk away” from a void marriage without waiting for a divorce or annulment.

Voidable Marriage

A voidable marriage is one that is initially invalid but remains in effect unless ended by a court order. For example, a marriage is voidable if either party was underage, drunk, or otherwise legally incompetent. Likewise, a marriage is voidable if one party used fraud, duress, or force to induce the other party to “agree” to the marriage. The parties may ratify an otherwise voidable marriage by words or conduct after the removal of the impediment that made the marriage voidable.

Ceremonial Marriage

A ceremonial marriage is a marriage performed according to a state statute. Most people prefer a ceremonial marriage to an informal or common-law marriage because a ceremonial marriage is easier to prove.

A license to marry is required, and is furnished by a state court or official upon approval of an application designed to check the parties' eligibility to marry. In most states, an application must state identifying information, information about each prior marriage of either applicant, that neither of the applicants is afflicted with a communicable disease, and other facts necessary to find whether there is a legal impediment to the proposed marriage. A refusal to issue a marriage license is reviewable by a court. An application for a marriage license is a public record.

Most states require at least a guardian's approval and sometimes a court's approval if either party is a minor or mentally incapacitated.

Most states provide that a judge, government official, or clergyperson may perform a ceremony. Some people use the term *civil marriage* to describe a ceremony led by a judge or government official, as distinguished from one solemnized by a clergyperson. Some states permit the parties to perform their marriage ceremony. Some states permit and others prohibit a proxy marriage, a ceremony in which someone stands in for an absent party.

A failure to comply with statutory rules does not necessarily result in a void marriage. Sometimes a defect makes a marriage voidable rather than void. In a state that permits common-law marriage, a defective ceremonial marriage often results in a valid common-law marriage.

A person who wants to prove that a marriage exists (or existed until the other person's death) may refer to the marriage certificate as evidence of the marriage's validity. Unless someone else shows persuasive evidence of a defect, a marriage certificate usually is strong evidence that the marriage occurred.

Same-Sex Marriage

Currently, a few states recognize a marriage between two persons of the same sex.

Massachusetts law provides that same-sex couples are entitled to marry, just as opposite-sex couples are.³⁸

Vermont law provides that a same-sex couple is entitled to choose the protections and duties of marriage. Although the Vermont statute calls a same-sex marriage a civil union, the protections and duties provided are those of marriage. New York law recognizes the parties to a Vermont civil union as spouses.

California, Hawaii, Maine, and New Jersey laws permit a same-sex couple to register their domestic partnership. It is unclear whether this relationship makes a domestic partner a spouse of his or her domestic partner.

Common-Law Marriage

A common-law marriage (perhaps more appropriately called an informal marriage) is a marriage that was not performed by a licensed ceremony, but was created by the simple agreement of the parties.

Each party to such a marriage must:

- Be legally capable of making a marriage contract.
- State his or her present agreement to the marriage (or to the relation of spouses).
- Agree to live with his or her spouse to the exclusion of all others.

Although some people mistakenly assume that a period of cohabitation results in a common-law marriage, this is not true under any state's law. Conversely, no period of cohabitation is necessary; the present agreement to the marriage is all that is needed.

If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing. Even an implication of consent to a marriage might be sufficient. Also, a marriage ceremony that had a defect is likely to result in a common-law marriage.

Usually, the absence of a ceremony (and the absence of witnesses, other than the parties) makes it difficult to prove that a common-law marriage exists or existed. Often, there is an evidence-law rule or presumption against the claimant testifying to the creation of the relationship. Courts consider evidence of how each person described the relationship to third persons, and how third persons understood the relationship. Either spouse's denial of the marriage in records such as a driver's license, Social Security claims, tax returns, insurance applications, bank accounts, and wage records does not necessarily deny a common-law marriage. The burden of proving a common-law marriage is on the person who asserts that it exists or existed.

³⁸ As we go to press, the domestic partner debate continues across the nation. Among other things, the question of whether such a union is to be referred to (and recognized) as a civil union or a civil marriage remains at issue. A recent court ruling in Massachusetts could allow the state to become the first to officially grant marriage licenses to same-sex couples.

Practice Pointer: If a client wants help in evaluating a claim of a common-law marriage, a CPA should refer such a client to an expert lawyer.

Recognizing Common-Law Marriage

Currently, Alabama, Colorado, the District of Columbia, Iowa, Kansas, Montana, New Hampshire (for survivorship only), Oklahoma, Rhode Island, South Carolina, Texas, and Utah recognize a common-law marriage made in its state now. But three states repealed common-law marriage in the 1990s, and recognize informal marriages made before the repeal. Likewise, many other states repealed common-law marriages not so long ago, and persons living now might have married before a state's repeal.

All states recognize a marriage that, even if it does not meet all requirements of local law, was valid under the laws of the state in which the spouses were present when they contracted the marriage. Likewise, states recognize a marriage made according to any Native American Indian law or custom. Further, some states that recognize common-law marriage internally recognize a marriage that the spouses entered into while they lived in another state, notwithstanding that the marriage was invalid in the other state.

Caution: *Because of the recognition that states give to the laws of other states and other nations, it is possible for a common-law marriage to exist anywhere in the USA. Although the states that recognize informal marriage are the minority, Americans' mobility enables informal marriages. Even a weekend trip across state lines could result in a marriage. Further, among those states that currently do not recognize common-law marriage, almost half allowed common-law marriage at a time when people still living now might have married.*

Common-Law Marriage and Retirement Benefits

How a common-law marriage might affect a retirement benefit turns on whether the benefit is provided under an ERISA plan or a non-ERISA plan.

ERISA

An ERISA plan usually provides (and must provide) that some or all of a plan benefit belongs to a spouse. If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing. A recognized common-law marriage is no less a marriage than is a ceremonial marriage.

Example. Gary and Zoe lived together in Alabama. Gary never made any beneficiary designation under his employer's ERISA-governed retirement plan. The plan provides that a surviving spouse is entitled to 100 percent of the participant's account. When Zoe calls Gary's former employer to ask about the plan benefit, the employer tells her that it has no record that Zoe is Gary's spouse. Zoe files the plan's claim form and attaches to it an affidavit that states facts that, if correct, would prove a common-law marriage under Alabama law. Because the employer, acting as plan administrator, does not re-

ceive any contrary information, it decides that Zoe is Gary's surviving spouse. The plan administrator instructs the custodian to pay the full benefit as Zoe requested.

Practice Pointer: A plan administrator must act as a prudent expert when deciding plan claims. Therefore, a plan administrator should get an expert lawyer's advice when evaluating any person's claim that he or she is the common-law spouse of a participant.

State Law

If a participant in a non-ERISA plan has a spouse, state law (or a Native American Indian tribe's law) may provide that some or all of the participant's plan benefit belongs to the spouse (as previously explained). If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing, and the common-law spouse will enjoy whatever rights the state affords a spouse.

Although a payor is protected in making a payment according to the beneficiary designation under a non-ERISA plan, a distributee of a benefit paid under the plan receives any payment subject to the rights of the spouse (including a common-law spouse).

Example. Hubert and Wilma lived in Kansas throughout their working lives. In early 1993, before Hubert met Wilma, Hubert named his brother, Bob, as the beneficiary under Hubert's IRA. Even after his marriage to Wilma in late 1993 and the birth of their children, Debbie in 1994 and Seth in 1996, Hubert did not change his beneficiary designation. After Hubert's retirement, Hubert and Wilma moved to New York. Hubert died without having made any will. After Hubert died, Bob sent in a claim to the IRA custodian, which paid Bob all of Hubert's retirement plan balance. On his death, Hubert's IRA balance was \$200,000 and his probate assets were \$60,000. There was nothing else.

For ease of illustration, both parts of this example omit family exemption, homestead allowance, funeral and administration expenses, debts, taxes of all kinds, and lawyers' fees.

If Wilma does not take an elective share of Hubert's augmented estate, Hubert's estate will be divided as follows:

Wilma	0	\$55,000	\$ 55,000	21%
Debbie	0	2,500	2,500	1%
Seth	0	2,500	2,500	1%
Bob	<u>\$200,000</u>	<u>0</u>	<u>200,000</u>	<u>77%</u>
Total	\$200,000	\$60,000	\$260,000	100%

If Wilma takes an elective share of Hubert's augmented estate, Hubert's estate will be divided as follows:

	Augmented Estate	Share
Wilma	\$ 86,666.67	33.33%
Debbie	0	
Seth	0	
Bob	<u>\$173,333.33</u>	<u>66.67%</u>
Total	\$260,000.00	100.00%

Because Hubert's probate estate is insufficient to pay Wilma the amount to which she is entitled, Bob must pay Wilma \$26,666.67 (\$86,666.67–\$60,000).

Dower or curtesy (which applies only in Arkansas, the District of Columbia, Kentucky, Ohio, and West Virginia) might provide a surviving spouse lifetime rights to the decedent's land (but not to personal property, such as retirement benefits).

Same-Sex Marriage

Massachusetts and Vermont expressly provide same-sex marriage.³⁹ Every other state refuses, whether lawfully or unlawfully, a marriage license to a same-sex couple. Nonetheless, a same-sex couple might marry in a state that permits common-law marriage. Notwithstanding statutes that try to restrict marriage to opposite-sex couples, a same-sex marriage might be a valid marriage if those statutes are unconstitutional.

Also, a state might recognize a marriage made in Belgium, Canada, the Netherlands, or another nation that provides same-sex marriage.

If same-sex couples are spouses under state law and the United States Code's general provision that same-sex couples are not spouses for any federal statute is unconstitutional, ERISA applies to a participant, his or her spouse, and their property rights as it applies for an opposite-sex couple.

If a same-sex couple resides in a state other than the state in which they married, a federal statute says that the current state need not recognize the marriage established in the other State.

³⁹ *Goodridge v. Department of Health*, 440 Mass. 309, 798 N.E.2d 941 (Mass. 2003); see also *In re Opinions of the Justices of the Senate*, 440 Mass. 1202, 802 N.E.2d 565 (Mass. 2004). However, a Massachusetts statute (based on the 1912 Uniform Marriage Evasion Act, later withdrawn by the National Conference of Commissioners on Uniform State Laws) states that an attempted or purported marriage in which at least one of the parties reside and intends to continue to reside in another state is void if the marriage would be void if "contracted" in the other state. Mass. Gen. Laws ch. 207, section 11 (Westlaw 2004). It is unclear whether this statute is law because it might be unconstitutional.

“No State . . . shall be required to give effect to any public act, record, or judicial proceeding of any other State . . . respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State . . . , or a right or claim arising from such relationship.”⁴⁰ It is unclear whether this statute is the law, because it may be unconstitutional.⁴¹

Practice Pointer: If a personal financial-planning client is in a same-sex couple union, and wants to name a beneficiary other than his or her spouse, a CPA should urge the client to get an expert lawyer’s advice.

Unusual Marriages

Other nations recognize marriages and other relationships that do not fit neatly into the English and American construct of marriage.

Most Americans assume that it is impossible for a person to have two legitimate spouses at the same time. That is not necessarily so if a person entered into a marriage in another nation. Although a U.S. state might choose not to recognize a marriage that it finds contrary to its strong public policy, a state may give deference to the customs and laws of another nation. At least one state court has held that a decedent can have more than one spouse for inheritance purposes.

However, a court may find that a relationship that is recognized under another nation’s law or custom is not the same kind of relationship that the U.S. state recognizes as a marriage.⁴² For example, a Florida court held that a “Union Marital de Hecho” (a marital union in fact) under Colombian law was not the equivalent of a common-law marriage. Likewise, a state will not recognize concubinage as a marriage.

Using Agreements to Change a Spouse’s Rights

A couple who are about to marry, or who already are married, may agree to change some of the property rights that come from marriage.

Premarital Agreements

A premarital agreement (sometimes called a *prenuptial* or *antenuptial* agreement) is an agreement made between two persons who are about to marry concerning property rights that arise from marriage. Typically, a premarital agreement provides that one or both of the soon-to-be spouses waive one or

⁴⁰ 28 U.S.C. Section 1738C.

⁴¹ See U.S. Constitution, article IV, section 1, and the Fifth Amendment; *Saenz v Roe*, 526 US 489, 119 S Ct 1518, 143 L Ed 2d 689, 67 USLW 4291, 61 Soc Sec Rep Serv 75, 1999 US LEXIS 3174 (1999); *Romer v Evans*, 517 US 620, 116 S Ct 1620, 134 L Ed 2d 855, 64 USLW 4353, 70 Fair Employ Prac Cases (BNA) 1180 (1996).

⁴² Laws in this area are constantly changing. See footnote 38.

more of the property rights that a spouse would otherwise have. Within limits required by public policy and basic fairness, a premarital agreement may specify what property division will apply if the marriage ends by divorce or when it ends by death. A premarital agreement may waive a spouse's right to a share of the other's estate.

Under the Uniform Premarital Agreement Act, the parties to a premarital agreement may contract concerning property rights, the support of a spouse or former spouse, making a will or trust, and "[t]he ownership rights in and disposition of the death benefit from a life insurance policy."

Usually, a premarital agreement must be written. In most states, a premarital agreement must be in a writing signed by the parties. In New York, a premarital agreement must be signed and sworn by each of the parties in the presence of a notary public or similar officer.

Many state statutes or court decisions impose additional requirements. Typically, each party should fully disclose his or her financial circumstances to the other. In some states, a person need not disclose an asset that was not subject to his or her control. Further, the better practice is for each party to get the advice of a lawyer of his or her choosing. In those states that do not regulate premarital agreements by statute, courts apply ordinary contract-law principles, but with extra scrutiny in recognition of the confidential relationship of those engaged to marry.

A court will enforce a premarital agreement that makes reasonable provision for the surviving spouse even in the absence of full and fair disclosure. A court will enforce an unreasonable agreement only if there was full and fair disclosure. A court will not enforce an agreement to the extent that doing so would cause a spouse to become eligible for public assistance.

In some circumstances, it might be difficult to enforce the terms of a premarital agreement. At least one court has held that an offset against contract rights in recognition of a surviving spouse's receipt of retirement benefits (which were not provided by the premarital agreement) could be an ERISA violation, notwithstanding that the person applying the offset had no connection to any ERISA plan. According to the court, that was the case because the offset had the effect of "discriminating" against the spouse because she exercised her right to a benefit under an ERISA plan.

Using a Premarital Agreement to Waive a Spouse's Right to a Retirement Benefit

The effect (if any) of a premarital agreement concerning a retirement benefit turns on whether the benefit is provided by an ERISA plan or a non-ERISA plan.

ERISA

A premarital agreement cannot waive a spouse's right to an ERISA plan benefit.

A premarital agreement rarely states all the form requirements necessary to state a valid spouse's consent to waive rights under an ERISA retirement plan.

A spouse's consent to a participant's qualified election must be signed by the spouse, and a person making a premarital agreement is not yet the spouse.

The IRS has stated its interpretation that a premarital agreement may not constitute a waiver of spouse's-consent rights.

All of the federal court decisions on this question have held that a premarital agreement cannot be used to waive a spouse's rights.

State Law

Even if a surviving spouse is entitled to an elective share, community property, or other protective rights under state law, an expertly prepared premarital agreement should be sufficient to eliminate or waive a spouse's right to a benefit under an IRA or other non-ERISA plan.

Marital Agreements

A marital agreement is an agreement made between two persons, who already are spouses, concerning property rights that arise from their marriage. Typically, a marital agreement provides that one (or both) of the spouses waives one or more of the property rights that a spouse would otherwise have. A marital agreement may waive one spouse's right to a share of the other's estate. Within limits required by public policy and basic fairness, a marital agreement may specify what property division will apply if the marriage ends in divorce or when it ends by death.

Usually, a marital agreement must be written. In most states, a marital agreement must be in a writing signed by the parties. In New York, a marital agreement must be signed and sworn by each of the parties in the presence of a notary public or similar officer.

Many state statutes or court decisions impose additional requirements meant to ensure basic fairness. Typically, each party should fully disclose his or her financial circumstances to the other. Further, the better practice is for each party to obtain the advice of a lawyer of his or her choosing. Some states require that the marital agreement be fair and equitable.

In Minnesota, a marital agreement is valid only if:

- Each spouse has a net worth of \$1.2 million.
- Each spouse has the advice of a lawyer of his or her choosing; and the couple stays married for at least two years.

In Louisiana and North Carolina, a marital agreement must be approved by a judge. In Hawaii, a marital agreement is valid only if the terms are fair at the time of the divorce.

A marital agreement is void if it was signed under a threat of a divorce.

Using a Marital Agreement to Waive a Spouse's Right to a Retirement Benefit

The effect (if any) of a marital agreement concerning a retirement benefit turns on whether the benefit is provided by an ERISA plan or a non-ERISA plan.

ERISA

A marital agreement may waive a spouse's right to a benefit under an ERISA plan if the agreement states the spouse's consent to a qualified election in a way that meet ERISA's and the plan's provisions. To do so, a marital agreement must state all form requirements necessary to state a valid spouse's consent.⁴³ To accomplish that, a family lawyer should consult an expert employee-benefits lawyer and the plan administrator.

Practice Pointer: If a client asks for information about how to state a spouse's consent, a CPA might suggest that the client get the retirement plan's forms.

State Law

A marital agreement may waive a spouse's right to a benefit under a non-ERISA retirement plan.

Even if a surviving spouse is entitled to an elective share, community property, or other protective rights under state law, an expertly prepared marital agreement should be sufficient to waive a spouse's right to a benefit under a non-ERISA retirement plan.

Charitable Gifts

A participant may name a charity as a beneficiary.

Practice Pointer: For a person who already has decided to make charitable gifts on death and expects his or her estate to be subject to a significant federal estate tax, some financial planners suggest that using a retirement plan benefit might be an efficient way to provide the gift. They suggest this because deferred compensation is subject to both federal income tax and federal estate tax, while a capital asset enjoys a "stepped-up" basis (except for deaths in 2010) and is not subject to income tax until the beneficiary sells the asset. Other planners point out that the federal income tax deduction for federal estate tax attributable to property that is income in respect of a decedent partially mitigates the double tax.⁴⁴ Along with this, they argue that a retirement plan might permit longer income tax deferral while post-death income on capital assets will subject the beneficiary to income tax. Considering which course might be "right" turns on the donor's and the planner's assumptions. Further, nontax factors might favor a particular approach.

⁴³ ERISA Section 205.

⁴⁴ See IRC Section 691(c).

Although a retirement benefit will be included in a participant's taxable estate for federal estate tax purposes, his or her estate will have a deduction for the amount that properly passes to charity.⁴⁵ Further, although a distribution from a retirement plan is included in income for federal income tax purposes, a charity does not pay federal income tax on its receipts from charitable gifts.⁴⁶

Death

A death benefit under a retirement plan turns on proving that a participant's death occurred. In some cases, it might matter when a death occurred. The following sections address the circumstances of simultaneous deaths and presumed deaths.

Simultaneous Deaths

There are a number of possible circumstances of simultaneous death, as addressed in the following:

Participant and a Beneficiary

For some retirement plans, the order in which a participant and his or her beneficiary die is irrelevant. Under some plans, a person cannot be a beneficiary if that person is not living when a benefit becomes distributable.

ERISA

If an ERISA plan's administrator must decide the order of deaths between a participant and a beneficiary, and the plan does not provide a presumption concerning the order of deaths, it might be prudent for a plan administrator to follow the Uniform Simultaneous Death Act or the Uniform Probate Code.

State Law

The 1940 Uniform Simultaneous Death Act, adopted by many states, provides that if "there is no sufficient evidence that the persons have died otherwise than simultaneously, the property of each person shall be disposed of as if he [or she] had survived [the other person]." The Uniform Probate Code provides that a person may not qualify as an heir unless he or she survived the first decedent for 120 hours. Further, the person who would claim through the heir has the burden of proving the duration that the heir survived the first decedent. The 1991 version of the Uniform Simultaneous Death Act has almost the same rule. A payor that decides claims under a non-ERISA plan might need to follow state law.

Caution: *A retirement plan's documents may vary the rules for deciding the order of deaths.*

⁴⁵ IRC Section 2055.

⁴⁶ IRC Section 501(a).

A common-disaster clause or a delay clause of up to six months does not disqualify property for the federal estate tax marital deduction.

Between or Among Potential Beneficiaries

ERISA

If an ERISA plan's administrator must decide the order of deaths between or among potential beneficiaries and the plan does not provide a presumption concerning the order of deaths, it might be prudent for a plan administrator to indulge a presumption that all persons who died within a few days of one another died at the same time and survived to the relevant time.

State Law

A plan administrator that decides claims under a non-ERISA plan might need to follow state law. Moreover, a bank, insurer, or broker-dealer that decides claims concerning an IRA or other non-ERISA plan might be required to follow state law, including banking, insurance, and securities laws.

Practice Pointer: For tax-planning purposes, a wealthy person might prefer to vary the "default" rules that apply to simultaneous deaths by express language in his or her beneficiary designation. Some plans follow such a provision in a beneficiary designation; other plans do not.

Presuming the Death of an Absentee

In ordinary circumstances, a plan administrator or payor should not presume a person's death. Instead, a plan administrator or payor should require the claimant (usually, the next beneficiary) to prove the absentee's death by a court order.

Under the common law, a person was presumed dead if he or she had been absent for a continuous period of seven years. Likewise, an absentee's exposure to a specific peril was a sufficient ground for presuming death. Further, death may be inferred if survival of the absentee would be beyond human expectation or experience. Courts sometimes required considerable evidence of an unexplained absence. For example, a person's absence from the places where his relatives resided along with his failure to communicate with his relatives was not enough to show that he was absent from his residence without explanation.

In 1939, the Uniform Absence as Evidence of Death and Absentees Property Act reversed the common-law rules that a person being absent for seven years (or any duration) or being exposed to a specific peril did not set up a presumption of death. Instead, these facts are merely evidence for a court or jury to consider in making its own decision on whether the absentee's death had occurred.

The Uniform Probate Code, portions of which many states have adopted, returns to a presumption. A person is presumed dead after he or she has been absent for a continuous period of years, which varies by state from three to seven years. However, someone who seeks a declaration of an absentee's death must prove to a court's satisfaction that the absentee was not heard

from after diligent search or inquiry, and that the absentee's absence is not satisfactorily explained.

Usually, the person who would benefit from the absentee's death bears the burden of proof.

Also, unless sufficient evidence proves that death occurred sooner, the end of the absence period is deemed the date of death.

Caution: *The presumption of an absentee's death does not apply to all property in the same way. Some states do not use the presumption to provide a life insurance or annuity death benefit.*

The terrorist attacks of September 11, 2001, focused renewed attention on laws that permit a finding of death based on exposure to a specific peril.

ERISA

An ERISA plan's administrator need not follow state law, and instead may make its own rules and use discretion in deciding whether or when a person's death occurred.

Disclaimer

A disclaimer (also called a *renunciation* in some states) is a writing in which a beneficiary says that he or she does not want to receive a benefit. To be legally effective and, if desired, to achieve tax-planning purposes, the disclaimer must carefully state certain conditions. (See below.)

A retirement plan generally will not permit a participant to disclaim his or her benefit, because a plan typically provides that a participant cannot assign or give away any right he or she has under the plan.⁴⁷ But a retirement plan might permit a beneficiary's disclaimer.⁴⁸ A plan administrator may (but need not) accept a beneficiary's disclaimer.

If a beneficiary makes a valid disclaimer, the benefit will be distributable as though the beneficiary had died before the participant's death.

Although people don't lightly turn away money, sometimes there is a good reason for a beneficiary to make a disclaimer. A typical reason is to complete tax-oriented estate planning. If a beneficiary makes a valid disclaimer that also meets all requirements of Internal Revenue Code (IRC or the Code) Section 2518, the disclaimed benefit will not be in the disclaimant's estate for federal estate tax purposes.⁴⁹ Many states have a similar rule for state death tax purposes, but some apply further restrictions. A surviving spouse, executor, or

⁴⁷ ERISA Section 206(d), IRC Section 401(a)(13).

⁴⁸ See General Counsel Memorandum (GCM) 39858 (September 9, 1991). See also Ltr. Ruls. 9226058 (Mar. 31, 1992), 9037048 (Jun. 20, 1990), 8922036 (Mar. 2, 1989).

⁴⁹ IRC Section 2518.

trustee might use a disclaimer to reduce the amount of property that becomes the subject of the federal estate tax marital deduction.

A frequent use of a disclaimer is to correct a “wrong” beneficiary designation.

Example. Larry has saved for retirement through his employer’s retirement plan. When he enrolled in the plan, he was single, and he named his older sister, Carol, as beneficiary. Recently, Larry was married to Marie. Shortly after returning from their honeymoon, Larry was killed in a traffic accident. Carol believes that if Larry had thought about it, he would have wanted his wife to be his beneficiary. Therefore, Carol files a disclaimer with the plan administrator. Although Carol cannot directly control who gets the benefit, her lawyer advised her that the plan’s “default” provision (explained earlier), together with the state’s intestacy law, will result in Marie’s receiving the benefit. Carol feels that is a morally sound result and what Larry would have wanted. The use of a disclaimer allows the family to achieve a good result.

Practice Pointer: A qualified disclaimer—if it is a disclaimer of all of a would-be beneficiary’s benefit—could change the designated beneficiary for the purposes of a retirement plan’s minimum-distribution provision.

Caution: A beneficiary should not make a disclaimer without first getting a lawyer’s advice that doing so will not be a federal healthcare crime.

Disclaimer by an Agent

If a retirement plan (other than an IRA) permits a beneficiary to disclaim a plan benefit, whether that power may be exercised only by the beneficiary personally or by the beneficiary’s executor, personal representative, guardian, or agent as a fiduciary depends on the plan’s language. Unless the plan states that a power to disclaim may be exercised by such a person, only the beneficiary personally may exercise the power to disclaim.

For an IRA that does not state whether an agent may disclaim a right under the IRA, it is unclear whether a similar result would apply under state law. In some states, a personal representative may disclaim an interest and the disclaimer relates back to the disclaimant’s death or even to the death of the person making the disclaimant a beneficiary.

Tax-Valid Disclaimer

To be effective for federal tax purposes, a disclaimer must meet the following conditions:

- The disclaimer must be made before the would-be beneficiary accepts or uses any benefit.

- The benefit must pass without any direction by the disclaimant.
- The disclaimer must be in writing and must be signed by the disclaimant.
- The writing must state an irrevocable and unqualified refusal to accept the benefit.
- The writing must be delivered to the plan administrator.
- The writing must be so delivered no later than nine months after the date of the participant's death or the date the beneficiary attains age 21 (whichever is later).
- The disclaimer must meet all requirements of applicable state law.⁵⁰

State law may impose further conditions. For example, in some states, a disclaimer must state the disclaimant's belief that he or she has no creditor that could be disadvantaged by the disclaimer. In some situations, especially when the beneficiary is a minor child or an incapacitated person, a disclaimer requires court approval. Even when court approval is not required, state law may require that a disclaimer is not valid unless filed in the appropriate probate court.

Practice Pointer: In most states, (unless the drafter is admitted to practice law) drafting a document that could affect a person's right is the unlawful practice of law. Even selecting a form published by the government might be the unlawful practice of law. Because the unlawful practice of law is a crime, it is also likely "an act discreditable to the profession."⁵¹ Even if a CPA does not suffer criminal prosecution or professional discipline, a CPA's malpractice insurance contract would not cover the practice of law.

Beyond state law and tax-law conditions, a plan might impose further requirements.

Government Claims

Medicaid

A retirement plan benefit probably is counted as an "available resource" for Medicaid eligibility purposes to the extent that the patient, or his or her spouse, currently has a legal right to receive payment under a plan.⁵²

⁵⁰ IRC Section 2518; GCM 39858 (September 9, 1991).

⁵¹ See American Institute of Certified Public Accountants, Code of Professional Conduct, Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.01), and accompanying Interpretations.

⁵² See 42 U.S.C. Sections 1396a–1396p.

Practice Pointer: Suggest that a client consider not selecting as his or her beneficiary a person likely to need Medicaid benefits if he or she could make a more appropriate beneficiary designation.

Caution: *A beneficiary should not make a disclaimer without first getting assurance from a lawyer that doing so will not be a federal healthcare crime.*

After using the “community-spouse-resource allowance,” a participant’s retirement plan benefit probably is counted as an “available resource” for his or her spouse’s Medicaid eligibility to the extent that the participant currently has a legal right to receive payment under a plan.

IRS Levy

Although ERISA’s anti-alienation rule reflects a policy that a participant’s retirement benefits should not be available to ordinary creditors, a U.S. tax lien or levy applies to ERISA plan amounts.⁵³ A U.S. tax lien or levy also supersedes any anti-alienation provisions of a non-ERISA plan. But a levy extends only to property rights that exist at the time of the levy.⁵⁴

If a participant has not yet severed from employment or reached age 59½, the IRS usually will not levy the participant’s retirement plan benefit (other than an IRA). The IRS will levy a participant’s retirement benefit only if he or she has been unusually abusive. A levy on retirement savings requires the approval of an IRS supervisor.⁵⁵

Unclaimed Property

ERISA

A state’s unclaimed property law does not apply to an ERISA plan.⁵⁶

Because a state’s unclaimed property law would, if applied, require delivery of plan assets and liabilities, such a law relates to the plan and its administration and thus ERISA preempts it. The Department of Labor (DOL) has consistently advised that ERISA preempts state abandoned-property laws.⁵⁷ Likewise, the secretary of labor has taken that position as a friend of the court.

State Law

Each of the 50 states (and the District of Columbia and U.S. possessions) has a law regulating abandoned or unclaimed property. For instance, the Uniform Disposition of Unclaimed Property Act, some form of which most states adopted, requires a person in possession of intangible property that is un-

⁵³ ERISA Section 514(d); IRC Section 6334(c); Treas. Reg. Section 1.401(a)-13(b)(2).

⁵⁴ Treas. Reg. Section 301.6331-1(a); see also ILM 200102021 (Oct. 5, 2000, rel. Jan 12, 2001).

⁵⁵ IRM paragraph 5.11.6.2.

⁵⁶ ERISA Sections 403(c)(1), 514(a).

⁵⁷ DOL ERISA Advisory Opinions 78-32A (Dec. 22, 1978), 79-30A (May 14, 1979), 83-39A (Jul. 29, 1983), 94-14A (Dec. 7, 1994).

claimed by its owner for a period of years (which varies by state and kind of property) to transfer that property to the state's custody.

Under most states' laws, an amount, property, or right under a non-ERISA retirement plan is not payable or distributable to measure a presumed abandonment period "unless, under the terms of the account or plan, distribution of all or part of the [money or property] would then be mandatory." Under many plans, a distribution is not required until the April 1 that follows the later of the participant's age 70½ or retirement. It is unclear how, if at all, this rule applies to an IRA. An IRA insurer or custodian ordinarily does not know whether a distribution is required because the owner or beneficiary might have taken his or her required distribution from another IRA.

Following such a required beginning date, a retirement plan account or benefit is presumed abandoned unless the distributee made contributions, accepted payment, or communicated about the account or benefit before the end of the abandonment period.

Tax-Oriented Estate Planning

Retirement Benefit Included in Federal Estate

With limited exceptions, the value of a participant's retirement benefits as of the date of his or her death is included in the participant's estate for federal estate tax purposes.⁵⁸ Or if payments have begun, the value of the remaining payments (if any) is included in the participant's estate for federal estate tax purposes.

Federal Estate Tax

The federal estate tax is a tax on the right to transfer property on death.⁵⁹ The tax is imposed on a decedent's taxable estate, which includes nonprobate property and rights. An unlimited marital deduction allows a person to transfer any amount to his or her surviving spouse without federal estate tax at that time, but tax may apply when the survivor dies.⁶⁰ A tax credit allows a person to transfer about \$1 million or more (as shown below) without federal estate tax.⁶¹

⁵⁸ IRC Sections 2033-2039.

⁵⁹ IRC Section 2001.

⁶⁰ IRC Section 2056.

⁶¹ IRC Section 2010(b).

Federal Estate Tax “Exemption”

Although the provision that “exempts” most estates from the federal estate tax really is a credit, many people express it as an approximately equivalent “exclusion” amount.⁶²

Exclusion Amount for Federal Estate Tax

For Estates of Decedents Dying During	Exclusion Amount
2002	\$1 million
2003	\$1 million
2004	\$1.5 million
2005	\$1.5 million
2006	\$2 million
2007	\$2 million
2008	\$2 million
2009	\$3.5 million
2010	No federal estate tax
2011	\$1 million

If all the unified credit against federal estate and gift taxes remains available and an estate's executor elects to use it, an estate may in effect exclude up to about the amount shown in the table above. For estates of decedents dying during 2010, there is no federal estate tax, but the federal gift tax generally applies on a gift other than a gift within the \$11,000 (for 2004) exclusion. For 2011 and later years, the federal tax law in effect before June 7, 2001 applies.

Practice Pointer: Many people have more wealth (at least for tax purposes) than they think. For estate tax purposes, a taxable estate includes nonprobate property, such as the following:

- A home
- Personally owned life insurance benefits
- Employment-based life insurance benefits
- Retirement benefits.

⁶² In one sentence that includes three subjunctives and conditions, IRC Section 2010(c) provides that “the applicable credit amount is the amount of the tentative tax which [sic] would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount[.]”

Example. Because Harry and Sally have young children and it takes both of their paychecks to run the household, they have a \$1 million life insurance contract on each other. They own their house, which is worth \$200,000. Harry's retirement plan accounts add up to \$900,000. (Although Harry does not consider himself wealthy, he's a millionaire—at least for federal estate tax purposes.) If either Harry or Sally dies, there will be no federal estate tax as long as all property passes to the surviving spouse. But if the second spouse dies during 2005, there will be a federal estate tax (assuming no deductions or credits), as much as about \$345,800 of which could have been avoided if Harry and Sally had planned gifts or trusts that would transfer some property or rights to their children before or on the death of the first parent to die.

Practice Pointer: A CPA might evaluate whether an estate-planning client should consider life insurance as a way to ensure that, after gifts to children or people other than the client's spouse, a surviving spouse will be adequately provided for.

Federal Estate Tax Marital Deduction

A retirement plan participant may provide for his or her spouse in a way that gets the federal estate tax marital deduction.

A beneficiary designation of a participant's spouse qualifies for the marital deduction as long as the spouse is the only person who can benefit, at least until his or her death.⁶³

A survivor annuity for the spouse qualifies for the marital deduction as long as the spouse is the only person who can benefit under the survivor annuity, at least until his or her death, the annuity qualifies for the marital deduction.⁶⁴

A beneficiary designation of a qualified terminable interest property (QTIP) trust qualifies for the marital deduction.

Qualified Terminable Interest Property Trust

If a trust agreement includes the necessary provisions, explained in the following list, and the executor and the trustee properly make the election, a (QTIP) trust qualifies for the marital deduction.

1. In addition to the usual requirements for a QTIP trust, a participant and his or her estate-planning lawyer should make sure that the trust (or at least the subtrust that will hold the retirement plan benefit) provides all of the following:
2. During the spouse's life, no one (including the spouse) may have any power to appoint any part of the retirement plan benefit or QTIP property resulting from it to anyone other than the surviving spouse.

⁶³ IRC Section 2056. See Let. Rul. 199936052 (June 16, 1999).

⁶⁴ IRC Section 2056.

3. The trustee has the power to make the retirement benefit and any trust property resulting from it productive or income earning.
4. The spouse has a right to require the trustee to make the retirement benefit and any trust property resulting from it productive or income earning.
5. The trust document does not change the definition of principal and income in a way that might result in less income distributable to the spouse.
6. The trustee has the power under the trust, and the right under the retirement plan, to obtain a distribution of the retirement benefit (subject to certain limitations and specific conditions, as described below).
7. The surviving spouse has the right to require the trustee to obtain a retirement plan distribution (subject to certain limitations and specific conditions, as described below). It is sufficient that the surviving spouse has the right to receive the income from the retirement plan benefit and the QTIP trust (it does not invalidate QTIP treatment if the surviving spouse chooses not to exercise that right).
8. The QTIP trust's fiduciary accounting income includes the retirement plan benefit's income.
9. To ensure the spouse's right to all the income, the administrative expenses normally charged to the corpus (including any income tax payable with respect to the distribution of principal) are charged to the corpus and not to income.
10. If necessary to administer the trust, the trustee must calculate the retirement plan benefit's fiduciary accounting income and the QTIP trust's fiduciary accounting income.
11. If (for a year) the surviving spouse exercises his or her right to receive all the trust's fiduciary accounting income, the QTIP trustee must claim a distribution from the retirement plan in an amount no less than the greater of the minimum distribution (including any incidental benefit required distribution) or the QTIP trust's fiduciary accounting income attributable to the retirement plan benefit.
12. The participant-decedent's executor and the trustee of the QTIP trust must make the QTIP election for the QTIP trust and for the retirement plan benefit also.

The preceding list is what mainstream estate-planning lawyers do.⁶⁵ But a QTIP trust, if it otherwise meets the requirements of the IRC, need not conform to all those elements. Instead, with expert guidance different provisions could cause a retirement benefit to be qualified terminable interest property.

⁶⁵ IRC Section 2056(b)(7); Treas. Reg. Section 20.2056(b)-5(f)(8), 20.2056(b)-7; Rev. Rul. 2000-2 (2000-3 IRB 305).

Practice Pointer: When confronted with this issue, remind an estate-planning lawyer that a retirement plan does not state provisions for distinguishing between income and principal. Therefore, a QTIP trust must provide for its trustee to decide income as a percentage of the QTIP trust's assets or based on the information available to the trustee. That information might be quite limited because ordinarily a retirement plan's trustee has no reason to keep records of whether a tax-exempt plan trust's investment changes reflect realized or unrealized capital gains, capital-gain distributions, dividends, interest, or other kinds of income.

Caution: *A surviving spouse who does not exercise his or her right to take all of the income from a retirement plan benefit, and thereby the QTIP trust's income, should consider whether his or her waiver or non-exercise of that right is a taxable gift of a future interest.*

Practice Pointer: A careful drafter of a QTIP trust might consider provisions that would preclude (or at least not authorize) an excessive trustee fee. If a trustee is a family member who is a natural object of the QTIP trust beneficiary's bounty, an excessive trustee fee is a taxable gift from the surviving spouse to the trustee.⁶⁶ In addition to gift tax on the portion of the trustee's fee that is in excess of reasonable compensation, a surviving spouse's acquiescence in an excessive fee might call into question whether the surviving spouse truly had a right to all of the trust's income and, thereby, whether the trust is or was a QTIP trust.⁶⁷

A participant might want to use a QTIP trust when he or she wants to use the federal estate tax marital deduction but does not want his or her spouse to receive a retirement plan benefit directly.

Example. Charles and Ellen, a married couple, have no children together, but Charles has children from a previous marriage. A QTIP trust can allow Charles to provide for Ellen during Ellen's life, while preserving some of the benefit for Charles's children.

Example. Beth cares very much for her husband, Ken, and wants her retirement plan benefit to provide for him if she dies first. But Beth believes that Ken is irresponsible when it comes to handling money and prefers that a professional trustee manage his financial needs. A QTIP trust could allow Beth to provide for Ken without putting all the money in his hands.

⁶⁶ TAM 200014004 (Dec. 10, 1999).

⁶⁷ IRC Section 2056(b)(7).

Qualified Domestic Trust for an Alien

Normally, an unlimited marital deduction is available for property passing to a decedent's surviving spouse. The deduction may apply to all or a portion of a retirement plan benefit to the extent that the decedent's surviving spouse is entitled to the benefit or the benefit is payable into a QTIP trust for the spouse's benefit. But if a person's spouse is an alien, the marital deduction is restricted, even if the alien spouse resides in the United States.⁶⁸

The federal estate tax marital deduction is available for a transfer to an alien spouse only if the property passing to the spouse is provided through a qualified domestic trust (QDOT).⁶⁹

A QDOT is a trust that holds assets for the benefit of (but not subject to the control of) the spouse during the spouse's life. The trust must restrict distributions during the spouse's life to trust income and hardship distributions, or else pay a special tax on any other distribution.⁷⁰ A QDOT must have at least one trustee who is a U.S. citizen, or a U.S. corporation must be responsible to pay any federal estate tax due from the trust.⁷¹ There are many further technical conditions specified by the Treasury regulations.⁷²

Practice Pointer: Designing a trust to get QDOT tax treatment involves an expert tax lawyer's advice. Do not suggest a general practitioner for this.

It is unlikely that a retirement plan will, by its own terms, meet the conditions for a surviving spouse's benefit to be treated as a QDOT. Therefore, a participant who wants QDOT treatment for his or her spouse's benefit should, with the advice of an estate-planning lawyer, choose a qualifying trustee and create a QDOT. The trustee and the surviving spouse must be careful to follow any further requirements particular to QDOT treatment for a retirement plan.⁷³

Practice Pointer: To cause any retirement plan benefit remaining on the participant's death to pass into the QDOT, the participant should change his or her beneficiary designation.

To preserve the marital deduction for a benefit passing to an alien spouse, the spouse must "transfer" his or her retirement plan distribution to a QDOT before the decedent's federal estate tax return is filed.⁷⁴ Of course, a beneficiary cannot assign or "transfer" a retirement plan distribution. But if an alien spouse receives a single-sum distribution and pays the proceeds into a QDOT before the estate tax return is filed, it might qualify for the marital deduction.

⁶⁸ IRC Sections 2056, 2056A.

⁶⁹ IRC Section 2056(d)(2).

⁷⁰ IRC Section 2056A(b).

⁷¹ IRC Section 2056A.

⁷² Treas. Reg. Sections 20.2056A-1 through 20.2056A-13.

⁷³ See, e.g., Let. Rul. 9713018 (Dec. 27, 1996).

⁷⁴ IRC Section 2056(d)(2)(B)(i).

The Treasury regulations also provide a special rule for annuity payments, but that rule is unlikely to be useful.⁷⁵

State Death Taxes

In addition to the federal estate tax, every state (except Nevada) imposes some form of death transfer tax. An estate tax is a tax on the privilege of transferring property from a decedent. An inheritance tax is a tax on the privilege of receiving property from a decedent, including even property that the decedent did not own at the time of his or her death. Unlike the marital deduction available under the federal estate tax, an inheritance tax or a state estate tax may apply even when the beneficiary is the decedent's spouse.

In some states, the amount of the state death taxes is the maximum amount for which the state death tax credit is available under federal estate tax law. In other states, the state death taxes often are more than that amount.

An explanation of particular states' inheritance or death transfer taxes is beyond the scope of this chapter. Some states tax retirement benefits for death transfer tax purposes according to rules similar to those for the federal estate tax. Other states have their own rules. In several states, the tax varies based on the relationship of the beneficiary to the participant-decedent. Some states do not tax life insurance proceeds in some circumstances.

Giving Advice About a Beneficiary Designation

A CPA might affirmatively present suggestions about beneficiary designations, especially in the course of an estate-planning or other financial-planning engagement. Or, a CPA might respond to a client's questions about a beneficiary designation.

Financial Planning

Depending on the scope of a financial-planning engagement, a CPA might ask a client about beneficiary designations. A person's right to name a beneficiary is a valuable right, and it is part of his or her financial planning. A professional would not want a client to lose a valuable opportunity just because the client was neglectful.

Further, asking someone who he or she named as his or her beneficiary often leads to a conversation about why the client wants to provide for the particular beneficiary. It often leads to a conversation about a family's life and financial needs. And it can help a CPA open a conversation about he or she might offer accounting, tax advice, and consulting services to meet some of those needs.

⁷⁵ Treas. Reg. Section 20.2056A-4.

Reading a Beneficiary-Designation Form

Plan administrators design beneficiary-designation forms anticipating the possibility that a participant might give incomplete or ambiguous instructions. For example, many forms provide that—if a participant has not specified the shares—an account will be divided among all beneficiaries in equal shares.

A beneficiary-designation form might include other “gap-fillers” or “default” provisions, some of which might be surprising to a participant. For example, a beneficiary-designation form might provide that a beneficiary change for an account will change the beneficiary for every account with the provider that is classified under the same IRC subsection. Some defined-contribution retirement plans provide as a “default” beneficiary the person or persons designated under a pension plan or even a life insurance plan. Because provisions of this kind might frustrate one’s intent, a careful participant should read the beneficiary-designation form.

Answering a Client’s Questions

A CPA may give practical advice about how to fill-in the beneficiary information requested by a retirement plan’s forms. However, he or she must not give advice about the legal effect of a beneficiary designation, unless that advice is incidental to tax advice that the CPA properly renders.

As mentioned earlier, except when done by a lawyer, giving legal advice, even for free, is a crime in almost every state. Even if a nonlawyer clearly warns that he or she is not a lawyer, it is still a crime to give legal advice. That a nonlawyer furnished information to a person who could not afford the services of a lawyer is not a defense to the nonlawyer’s unauthorized practice of law.

Even if he or she is not worried about criminal prosecution or losing his or her accounting or other licenses, a CPA might be more concerned about liability to his or her client. A person’s warning that he or she has not given legal advice does not protect him or her from responsibility if in fact he or she gave legal advice. Even a client’s signature on a written confirmation that a person had not given legal advice does not protect the person if in fact he or she gave legal advice. Courts have not hesitated to impose liability on a nonlawyer for giving incorrect or even incomplete advice. It is not a defense that a reasonable person should know that he or she cannot expect legal advice from a nonlawyer; instead, courts have found that circumstances sometimes make it reasonable to believe a nonlawyer would give legal advice. A nonlawyer will be held to the same standard of care and expertise as a lawyer. This duty, even for a nonlawyer, includes a duty to have and use specialist expertise, or to refer one’s client to an appropriate specialist.

Practice Pointer: A CPA's malpractice insurance contract cannot cover the practice of law. Also, notwithstanding exceptions for professionals, a CPA who renders advice or makes statements beyond his or her licensed profession remains vulnerable to claims and remedies under a state's consumer-fraud statute.

Many people believe that they cannot afford legal advice. Although a CPA should urge a client to seek a lawyer's advice, often it is impractical to avoid a client's questions. Try to answer questions by referring to widely known general information that does not involve applying the law to a specific factual situation.

Practice Pointer: If someone wants to make a beneficiary designation that would provide anything less than 100 percent of his or her death benefit for his or her spouse, urge him or her to seek the advice of an expert lawyer.

Involving Other Professionals

Making a beneficiary designation under a retirement plan or an IRA is an important part of estate planning. Although a plan's benefit will not pass by a will (as explained earlier), a beneficiary designation affects a person's overall estate plan.

A participant should make sure that his or her lawyer knows what beneficiary designation he or she made under each plan, and should ask the lawyer for advice about whether to change any beneficiary designation. Likewise, if a client looks to a CPA for advice in planning concerning estate and inheritance taxes, such a participant should give the CPA copies of all beneficiary designations.⁷⁶

Experts on the law of wills, trusts, and estates have observed that many Americans die with several "wills"—maybe one that was written in a lawyer's office and a dozen others that were filled out on standard forms. For most people, those forms—that is, beneficiary designations—dispose of far more money and property than the will does.

Common Mistakes

Because people enroll in retirement plans quickly, they sometimes make beneficiary designations that are less than carefully considered. Consider the following explanation of some common mistakes:

1. *Failing to coordinate a beneficiary designation's provisions with those made in other nonprobate designations, trusts, and a will.* Although a beneficiary designation's provisions need not be the same as those of a

⁷⁶ See also *The Team Approach to Tax, Financial & Estate Planning* by Lance Wallach (AICPA, 2003).

participant's will or other dispositions, if they are different the maker should understand why he or she has made different provisions and whether they are likely to add up to a combined result that he or she wants.

2. *Failing to consider whether a beneficiary designation is consistent with tax-oriented planning.* A participant might have had a lawyer's or CPA's advice about how to leave his or her estate, including both probate and nonprobate property, to achieve a desired tax outcome. Making a beneficiary designation without counting its effect on the maker's tax-oriented plan could result in an unanticipated tax.
3. *Making a beneficiary designation that a plan administrator or payor will refuse to implement.* For example, a person might try to make a beneficiary designation that refers to terms that one may use in a will or trust but are precluded by his or her retirement plan. A plan administrator's or payor's interpretation of the beneficiary designation without the offending terms might result in a disposition quite different from what the participant would have wanted.
4. *Trying to name beneficiaries by writing "all my children, equally" or describing a class.* Whenever a beneficiary designation refers to information not in a retirement plan's records, a plan administrator or payor may decide that the participant did not make a beneficiary designation, or might allow a claimant an opportunity to name every person in the class and prove that there are no others. Since it is difficult to prove the nonexistence of an unidentified person, even the opportunity to correct such a beneficiary designation would result in significant frustration and delay.
5. *Neglecting to use a beneficiary's Social Security Number or Individual Taxpayer Identification Number, especially for a daughter.*

Example. Gary Smith named his three children—Reed Smith, Catherine Smith, and Alice Smith—as his beneficiaries, and used only their names. By the time of Gary's death many years later, Reid and Alice had married. Reed had no special difficulty claiming his benefit. But Alice Carpenter was required to submit proof that she is the same person as Alice Smith. Because an identifying number assigned by the Social Security Administration or IRS is unique, this burden could have been avoided had Gary put Alice's number on the beneficiary-designation form.

6. *Naming a minor as a beneficiary without considering who the minor's guardian would be.* For example, a divorced person might not want to name his or her young child as a beneficiary if doing so might have the effect of putting money in the hands of the child's other parent, namely, the participant's former spouse. Instead, a participant might name a suitable trustee or custodian.
7. *Naming a child as a beneficiary without considering his or her prudence.*

Example. Ralph names his daughter, Britney, as beneficiary of Ralph's custodial account. When Ralph dies, Britney is 19 years old, and no longer is a minor under applicable law. Although Britney should pay her sophomore year's \$25,000 tuition at the Newark College of Fashion Arts, Britney buys a new car, and then neglects to pay the second insurance premium. When the uninsured car is stolen, Britney has nothing left from her father's gift.

8. *A participant who wants to benefit his or her child might consider that person's maturity, and consider whether it could help to choose a suitable trustee to manage the child's benefit.*
9. *Forgetting to give a copy of the beneficiary designation to the beneficiary.* A plan administrator or payor has no duty or obligation to contact a participant's beneficiaries to invite them to submit a claim. Indeed, many financial-services providers particularly avoid doing so because such a communication might invite fraudulent claims. A beneficiary might not claim a benefit if he or she is unaware that he or she is a beneficiary. Likewise, a beneficiary might face difficulty in claiming a benefit if he or she does not know the name of the plan administrator or payor.
10. *Naming one's estate as his or her beneficiary.* Some participants think that naming one's estate as beneficiary is a way to avoid inconsistency in his or her estate plan. Although such a beneficiary designation might fulfill a goal of avoiding inconsistency, it bears other consequences, which might be disadvantageous. Amounts paid or payable to an executor or personal representative for the estate are available to a decedent's creditors. And a benefit's "run" through an estate might, because of accounting and timing differences, result in income taxes greater than the income tax that would result if the recipient received the benefit directly.⁷⁷
11. *Although this observation might seem somewhat inconsistent with some just described, another common mistake is failing to make a beneficiary designation.* A participant who has difficulty making up his or her mind about a beneficiary designation is unlikely to have read a plan's documents carefully enough to understand the effect of the plan's "default" provision. Although a young person might assume that death is far away, the point of a beneficiary designation is to provide for the possibility of death.

Practice Pointer: When a CPA senses "analysis paralysis," he or she might suggest that the risks of failing to make a beneficiary designation outweigh the risks of a less than perfectly considered beneficiary designation. Remind a client that a typical plan allows a participant to change his or her beneficiary designation at any time.

⁷⁷ IRC Sections 1, 72, 641-691.

12. *Forgetting to review one's beneficiary designation.* A participant should review his or her beneficiary designations on a periodic basis, and whenever there is a significant change in his or her family or wealth.

Example. Nancy named her husband, Larry, as her beneficiary under an ERISA plan. Although Nancy wanted to make sure that her children would be provided for, she trusted her husband to take care of the whole family. Nancy and Larry divorced, and Nancy neglected to change her beneficiary designation. After Nancy's death, Larry submits his claim to the plan administrator. The plan administrator follows the plan's terms, which do not revoke a beneficiary designation because of a participant's divorce. The plan pays Larry, and he spends the money without considering any needs of Nancy's children.

The examples and common mistakes explained above are only a few of the many ways a participant might make an unwise beneficiary designation. Although a retirement benefit is meant to be consumed mostly during a participant's retirement years, death always is possible. So a participant should use his or her valuable right to name a beneficiary, and use that right with care.

Additional Resources

This list is arranged in alphabetical order of the publishers.

AICPA Resources on Professional Practices

The following resources focus on the professional practices and procedures a CPA should use in performing services mentioned in this chapter:

- American Institute of Certified Public Accountants (AICPA) *www.AICPA.org*.
- AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans* (2004).
- Anthony E. Davis, Marcia Gordon, and Robert H. Spencer, *Risk Management: A CPA Toolkit for a Changing Environment* (2003).
- Lance Wallach, *A CPA's Guide: The Team Approach to Tax, Financial & Estate Planning*, AICPA (2004).
- These publications are available at *www.CPA2biz.com*.

Pension Answer Book Series (Aspen Publishers)

Primarily question and answer format of particular topics in the pension area, relevant titles include:

- Life Insurance Answer Book
- SIMPLE, SEP, and SARSEP Answer Book
- Quick Reference to IRAs

- 403(b) Answer Book
- 457 Answer Book
- Roth IRA Answer Book

Resources on Laws That Relate to Beneficiary Designations

Although a CPA who is not also a lawyer is unlikely to render specific legal advice about the effect of a beneficiary designation, a general background in relevant law might improve a CPA's accounting, auditing, financial planning, and tax services. The following resources focus on broad patterns of laws in the United States.

American Law Institute

- Restatement of the Law Governing Lawyers (2001)
- Restatement of the Law of Conflict of Laws (1957)
- Restatement of the Law of Property—Wills and Other Donative Transfers (1999)
- Restatement of the Law of Trusts (1959)

National Conference of Commissioners on Uniform State Laws

- Determination of Death Act (1980)
- Disclaimer of Property Interests Act (1999)
- Disposition of Community Property Rights at Death Act (1971)
- Durable Power of Attorney Act (1987)
- Marital Property Act (1983)
- Marriage and Divorce Act (1973)
- Nonprobate Transfers on Death (1989)
- Notarial Acts (1982)
- Premarital Agreement Act (1983)
- Principal and Income Act (2001)
- Probate Code (1998)
- Simultaneous Death Act (1993)
- Transfers to Minors Act (1986)
- Transfers under Nontestamentary Instruments Act (1978)
- Trust Code (2000)
- Unclaimed Property Act (1995)

Chapter 21

Form 5500 Series Filing Requirements and Audit Waivers for Small Pension Plans

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Form 5500 Series Filing Requirements and Audit Waivers for Small Pension Plans

This chapter discusses the general Form 5500 and Form 5500-EZ filing requirements, exceptions from filing Forms 5500 and 5500-EZ, and the conditions for small employee-benefit plans (generally those with fewer than 100 participants) to be exempt from the general requirement that plans be audited each year by an independent qualified public accountant (IQPA) as part of the plan's annual report on Form 5500, when applicable.

Form 5500 Series Filing Requirements

The Form 5500 Series, Annual Return/Report of Employee Benefit Plan, is used to report information concerning employee-benefit plans and direct filing entities (DFEs). The administrator or sponsor of an employee-benefit plan subject to ERISA must file information about each plan every year. Various schedules may have to be attached.

The Internal Revenue Service (IRS), Department of Labor (DOL), and Pension Benefit Guaranty Corporation (PBGC) have consolidated certain returns and report forms to reduce the filing burden for plan administrators and employers. Employers and administrators who comply with the instructions for the Form 5500 and schedules will generally satisfy the annual reporting requirements for the IRS and DOL¹ with that agency.

¹ PBGC covered plans have special additional requirements, including filing an Annual Premium Payment (PBGC Form 1 Packages) and reporting certain transactions directly.

Who Must File Form 5500, Annual Return/Reports

A Form 5500, Annual Return/Report, must be filed every year for every pension-benefit plan, welfare-benefit plan, and for every entity that files as a DFE.²

Pension-Benefit Plan

All *pension-benefit plans* covered by the Employee Retirement Income Security Act of 1974, as amended (ERISA) are generally required to file a Form 5500. The return/report is due whether or not the plan is qualified, and even if benefits no longer accrue, contributions were not made during the plan year, or contributions have been discontinued. Pension-benefit plans required to file include both defined-benefit plans and defined-contribution plans. The following are among the pension-benefit plans for which an annual return and report must be filed:

1. Profit-sharing, stock bonus, money-purchase, and 401(k) plans, including savings incentive match plans for employees (SIMPLE), minimum required distribution (MRD) SIMPLE 401(k) plans, and so on
2. Annuity arrangements under Internal Revenue Code (IRC or the Code) Section 403(b)(1)
3. Custodial accounts established under IRC Section 403(b)(7) for regulated investment company stock
4. IRA established by an employer under IRC Section 408(c).
5. Pension-benefit plans maintained outside the United States primarily for nonresident aliens, if the employer who maintains the plan is a domestic employer or a foreign employer with income derived from sources within the United States (including foreign subsidiaries of domestic employers) if contributions to the plan are deducted on its U.S. income tax return
6. Church pension plans electing coverage under IRC Section 410(d)
7. Pension-benefit plans that cover residents of Puerto Rico, the U.S. Virgin Islands, Guam, Wake Island, or American Samoa³

Form 5500 Schedules

The following schedules may be required to be attached to Form 5500.

- *Schedule A, Insurance Information.* This is required if any benefits under an employee-benefit plan are provided by an insurance com-

² IRC Section 6058; ERISA Sections 104 and 4065.

³ This includes a plan covering residents of Puerto Rico that elects to have the provisions of ERISA Section 1022(i)(2) regarding exemption from tax apply.

pany, insurance service, or other similar organization.⁴ This includes investment contracts with insurance companies, such as guaranteed investment contracts (GIC) and pooled separate accounts (PSA).

Note. Schedule A is not required for an administrative services only (ASO) contract or if a Schedule A is filed for the contract as part of the Form 5500 filed directly by a master trust investment account. In addition, Schedule A is not required if the plan covers only (1) an individual or an individual and his or her spouse who wholly own a trade or business, whether incorporated or unincorporated; or (2) partners or partners and one or more of the partner's spouses in a partnership.

- *Schedule B, Actuarial Information.* Actuarial information is required for most defined-benefit pension plans and for defined-contribution pension plans that currently amortize a waiver of the minimum funding.
- *Schedule C, Service Provider Information.* Service provider information is required for a large plan, or group insurance agent (GIA) if:
 - Any service provider who rendered services to the plan or DFE during the plan or DFE year received \$5,000 or more in compensation, directly or indirectly from the plan or DFE, or
 - An accountant and/or enrolled actuary has been terminated.
- *Schedule D, DFE/Participating Plan Information.* This schedule captures DFE and participating plan information. Part I is required for a plan or DFE that invested or participated in any master trust investment account (MTIA), 103-13 investment entity (IE),⁵ common/collective trust (CCT), and/or in a group insurance arrangement (GIA). However, plans that participate in CCT, PSA, GIA, or 103-12 Investment Entities (IEs) that file as DFEs generally are eligible for certain annual reporting relief.

Caution: Different requirements apply to the Schedules D and H attached to the Form 5500 filed by plans and DFEs participating in CCTs and PSAs, depending upon whether a DFE Form 5500 has been filed for the CCT or PSA. See the instructions for these schedules.

- *Schedule E, ESOP Annual Information.* Employee stock ownership plan (ESOP) annual information is required for all pension benefit plans with ESOP benefits. For additional information, see the Schedule E instructions.
- *Schedule G, Financial Transaction Schedules.* Financial transaction information is required for a large plan, MTIA, IE, or GIA when

⁴ Such as Blue Cross, Blue Shield, or a health maintenance organization.

⁵ DOL Reg. Section 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than a MTIA, CCT, or PSA), whose underlying assets include plan assets. See DOL Reg Section 2510.3-101.

Schedule H, Financial Information lines 4b, 4c, and/or 4d are checked *yes*. Part I of the Schedule G reports loans or fixed income obligations in default or classified as uncollectible. Part II of the Schedule G reports leases in default or classified as uncollectible. Part III of the Schedule G reports nonexempt transactions.

Note. An unfunded, fully insured, or combination unfunded/insured welfare plan with 100 or more participants exempt from completing Schedule H⁶ must still complete Schedule G, Part III, to report nonexempt transactions.

- *Schedule H, Financial Information.* Financial information is required for pension-benefit plans filing as *large plans*, and for all DFE filings. Schedule H filers are generally required to engage an IQPA and attach a report.⁷ These plans and DFEs are also generally required to attach to the Form 5500 a Schedule of Assets (Held At End of Year), and, if applicable, a Schedule of Assets (Acquired and Disposed of Within Year), and a Schedule of Reportable Transactions. For additional information and exceptions, see the Schedule H instructions.
- *Schedule I, Financial Information.* Financial information is required for all pension-benefit plans filing as *small plans*, except for certain unfunded plans and certain insured plans and arrangements⁸ and limited plan reporting situations.
- *Schedule P, Annual Return of Fiduciary of Employee Benefit Trust.* This may be filed to satisfy the requirements for an annual information return from every IRC Section 401(a) organization exempt from tax under IRC Section 501(a).⁹ Filing this form will start the statute of limitations for any IRC Section 401(a) qualified plan, which is exempt from tax under IRC Section 501(a).¹⁰
- *Schedule R, Retirement Plan Information.* This is required for a pension-benefit plan that is a defined-benefit plan or is otherwise subject to IRC Section 412 or ERISA Section 302 regarding minimum funding requirements.
- *Schedule SSA, Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits.* This may be needed to report separated participants.
- *Schedule T, Qualified Pension Plan Coverage Information.* This generally is required for a pension-benefit plan that is intended to be a qualified plan under IRC Section 401(a) or IRC Section 403(a).

⁶ DOL Reg. Section 2520.104-44.

⁷ Pursuant to ERISA Section 103(a)(3)(A).

⁸ DOL Reg. Section 2520.104-44(b)(2).

⁹ IRC Section 6033(a).

¹⁰ IRC Section 6501(a).

Limited Plan Reporting

Certain plans and arrangements are eligible for limited annual reporting, they are:

- *403(b) Arrangements.* A pension plan or arrangement using a tax deferred annuity arrangement under IRC Section 403(b)(1) and/or a custodial account for regulated investment company stock under IRC Section 403(b)(7) as the sole funding vehicle for providing pension benefits need complete only Form 5500, Part I and Part II, lines 1 through 5, and 8. (Enter pension feature code 2L, 2M, or both.)

Note. The administrator of an arrangement described above is not required to engage an IQPA, attach an accountant's opinion to the Form 5500, or attach any schedules to the Form 5500.

- *IRA Plans.* A pension plan utilizing individual retirement accounts or annuities¹¹ as the sole funding vehicle for providing pension benefits need complete only Form 5500, Part I and Part II, lines 1 through 5, and 8. (Enter pension feature code 2N.)
- *Fully Insured Pension Plan.* Special reporting requirements apply to a pension-benefit plan providing benefits exclusively through an insurance contract or contracts that are fully guaranteed and that meet special requirements during the entire plan year.¹² Such a plan is exempt from attaching Schedule H, Schedule I, and an accountant's opinion, and from the requirement to engage an independent qualified public accountant.
- *Nonqualified Pension-Benefit Plans Maintained Outside the United States.* Nonqualified pension-benefit plans maintained outside the United States primarily for nonresident aliens required to file a return and report must complete the Form 5500 only. (Enter 3A in Part II, line 8a.)

Small Pension Plans

Generally, a return and report filed for a pension-benefit plan that covered fewer than 100 participants as of the beginning of the plan year should be completed following the requirements for a small plan. A return and report filed for a plan that covered 100 or more participants as of the beginning of the plan year should be completed following the requirements below for a large plan.

¹¹ IRC Section 408.

¹² DOL Reg. Section 2520.104-44(b)(2).

Practice Pointer: Use the number of participants required to be entered in line 6 of the Form 5500 to determine whether a plan is a small plan or large plan.

The 80-120 Participant Rule Exception

If the number of participants reported on line 6 is between 80 and 120, and a Form 5500 was filed for the prior plan year, the plan administrator or sponsor may elect to complete the return and report in the same category (large plan or small plan) as was filed for the prior return and report.

Example. A return and report was filed for the 2004 plan year as a small plan, including the Schedule I if applicable, and the number entered on line 6 of the 2005 Form 5500 is 100 to 120. The plan administrator or sponsor may elect to complete the 2005 Form 5500 and schedules in accordance with the instructions for a small plan.

Short Plan Year Rule

If the plan had a short plan year of seven months or less for either the prior plan year or the plan year being reported on the Form 5500, an election can be made to defer filing the accountant's report.¹³ If such an election was made for the prior plan year, the Form 5500 must be completed following the requirements for a large plan, including the attachment of the Schedule H and the accountant's reports, regardless of the number of participants entered in Part II, line 6.

The following schedules, including any additional information required by the instructions to the schedules, must be attached to a Form 5500 filed for a small pension plan:

1. Schedule A (as many as needed), to report insurance, annuity, and investment contracts held by the plan
2. Schedule B, to report actuarial information, if applicable
3. Schedule D, Part I, to list any CC T, PSA, MTIA, and IE in which the plan participated at any time during the plan year
4. Schedule E, to report ESOP annual information, if applicable
5. Schedule I, to report small plan financial information, unless exempt

Practice Pointer: If Schedule I, line 4k, is checked no, attach a report of the IQPA or a statement that the plan is eligible and elects to defer attaching the IQPA's opinion "pursuant 29 CFR 2520.104-50" in connection with a short plan year of seven months or less.

6. Schedule P (as many as needed), to report trust fiduciary information, if applicable

¹³ DOL Reg. Section 2520.104-50.

7. Schedule R, to report retirement plan information, if applicable
8. Schedule SSA (as many as needed), to report separated vested participant information, if applicable
9. Schedule T (as many as needed), to report tax qualified pension plan coverage information, if applicable

Large Pension Plans

The following schedules, including any additional information required by the instructions to the schedules, must be attached to a Form 5500 filed for a large pension plan:

1. Schedule A (as many as needed), to report insurance, annuity, and investment contracts held by the plan
2. Schedule B, to report actuarial information, if applicable
3. Schedule C, to list the 40 most highly compensated service providers and, if applicable, any terminated accountants or enrolled actuaries
4. Schedule D, Part I, to list any CCTs, PSAs, MTIAs, and IEs in which the plan invested at any time during the plan year
5. Schedule E, to report ESOP annual information, if applicable
6. Schedule G, to report loans or fixed income obligations in default or determined to be uncollectible as of the end of the plan year, leases in default or classified as uncollectible and nonexempt transactions
7. Schedule H, to report financial information, unless exempt

Practice Pointer: Attach the report of the IQPA identified on Schedule H, line 3c, unless line 3d(2) is checked.

8. Schedule P (as many as needed), to report trust fiduciary information, if applicable
9. Schedule R, to report retirement plan information, if applicable
10. Schedule SSA (as many as needed), to report separated vested participant information, if applicable
11. Schedule T (as many as needed), to report tax qualified pension plan coverage information, if applicable

Arrangements Not Required to File Form 5500

Form 5500 is not required for a plan if the plan is:

1. An unfunded excess-benefit plan¹⁴
2. An annuity or custodial account arrangement under IRC Section 403(b)(1) or (7) not established or maintained by an employer¹⁵

¹⁴ ERISA Section 4(b)(5).

¹⁵ DOL Reg. Section 2510.3-2(f). No contributions are made by the employer and the employer's involvement is limited.

3. A SIMPLE utilizing SIMPLE IRAs¹⁶
4. A simplified employee pension (SEP) or a salary-reduction or elective SEP (SARSEP) that conforms to either of the alternative method of compliance¹⁷
5. A church plan not electing coverage under IRC Section 410(d)
6. A pension plan that is a qualified foreign plan¹⁸
7. An unfunded pension plan for a select group of management or highly compensated employees (top-hat plan) that has timely filing of a registration statement with the DOL¹⁹
8. An unfunded dues financed pension-benefit plan that meeting the alternative method of compliance²⁰
9. An IRA not considered a pension plan under ERISA, meaning that no contributions are made by the employer and the employer's involvement is limited.²¹
10. A governmental plan²²

Form 5500-EZ

Form 5500-EZ may be filed instead of Form 5500 if all of the following conditions apply:

1. The plan is the one-participant plan of an incorporated or unincorporated business and the plan either covers only:
 - a. A sole-proprietor or a sole-proprietor and his or her spouse; or
 - b. One or more partners (or partner(s) and spouse(s)) in a business partnership.
2. The plan meets the minimum coverage requirements of IRC Section 410(b) without being combined with any other plan covering other employees of a business.
3. The plan does not provide benefits for anyone except you, or you and your spouse, or one or more partners and their spouses.
4. The plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control.
5. The plan does not cover individuals of a business that uses leased employees.

¹⁶ IRC Section 408(p).

¹⁷ IRC Section 408(k); DOL Reg. Section 2520.104-48 or 2520.104-49.

¹⁸ IRC Section 404A(e).

¹⁹ DOL Reg. Section 2520.104-23.

²⁰ DOL Reg. Section 2520.104-27.

²¹ DOL Reg. Section 2510.3-2(f). See, too, DOL Reg. Section 2510.3-2(d).

²² ERISA Sections 3(32), 4(b)(1).

Form 5500-EZ (or Form 5500) does not have to be filed if the preceding five conditions are satisfied, the plan does not have an accumulated funding deficiency²³ for the plan year, and the plan:

- Is a one-participant plan that had total plan assets of \$100,000 or less at the end of every plan year beginning on or after January 1, 1994, or
- When combined with one or more one-participant plans, has total plan assets of \$100,000 or less at the end of every plan year beginning on or after January 1, 1994.

Note. Neither Schedule H, Financial Information (Small Plan), or Schedule I, Financial Information, is required if a Form 5500-EZ is filed. (See the discussion of small plan audit waivers in the following section.) Only Schedules B, Actuarial Information; E, ESOP information; and P, Trust Fiduciary Information, apply to Form 5500-EZ filers.

Audit Waivers for Small Pension Plans

The DOL's regulation establishes conditions for small employee-benefit plans (generally those with fewer than 100 participants) to be exempt from the general requirement under Title I of ERISA that plans be audited each year by an IQPA as part of the plan's annual report, namely, Form 5500.²⁴

Plans Eligible for Waiver

Retirement plans with fewer than 100 participants at the beginning of the plan year are eligible for an audit waiver if they meet certain conditions. All Schedule I, Financial Information—Small Plan, filers that meet the conditions of the audit waiver are eligible. If the plan meets the conditions of the “80- to 120-participants” rule, it may file as a small plan and attach Schedule I instead of Schedule H to its Form 5500. Under the 80- to 120-participant rule, if the number of participants covered under the plan as of the beginning of the plan year is between 80 and 120, and a small plan annual report was filed for the prior year, the plan administrator may elect to continue to file as a small plan.²⁵ The plan administrator must disclose to participants, beneficiaries and the DOL that it is claiming the waiver.²⁶

Example. Schedule I was filed for the plan for the 2004 plan year and the plan covered fewer than 121 participants as of the beginning of the 2005 plan year. Schedule I may be completed instead of Schedule H.

²³ As defined in IRC Section 412(a)(2).

²⁴ DOL Reg. Section 2520.104-46 (43 FR 10151, Mar. 10, 1978, as amended at 43 FR 14010, Apr. 4, 1978; 45 FR 51447, Aug. 1, 1980; 54 FR 8629, Mar. 1, 1989; 65 FR 21067, Apr. 19, 2000; 65 FR 62957, Oct. 19, 2000).

²⁵ DOL Reg. Section 2520.104.46(d)(3).

²⁶ By checking *yes* on Line 4k of Schedule I of the Form 5500 filed for the plan.

If a plan meets another exception to the IQPA audit requirement, for example, if it is a small plan that is not required to complete Schedule I (such as a SEP that is exempt from the audit requirement), it does not have to meet the conditions for an audit waiver.

Caution: *A small plan electing to file as a large plan pursuant to the 80- to 120-participant rule can not claim the small plan audit waiver.²⁷*

Note. Small plans that do not meet the audit waiver conditions still file Schedule I, but must attach the report of an IQPA to their Form 5500.²⁸ Filers also do not need to include a schedule of assets held for investment or a schedule of reportable transactions, Schedule C, or Schedule G.

General Conditions for Audit Waiver

In addition to being a small pension plan filing the Schedule I, there are three basic requirements for a small pension plan to be eligible for the audit waiver, as follows:

1. As of the last day of the preceding plan year, at least 95 percent of a small pension plan's assets must be qualifying plan assets. Alternatively, if less than 95 percent are qualifying plan assets, then any person who handles assets of a plan that do not constitute qualifying plan assets must be bonded in an amount that at least equal to the value of the nonqualifying plan assets he or she handles.²⁹
2. The plan must include certain information in the Summary Annual Report (SAR) furnished to participants and beneficiaries in addition to the information ordinarily required.³⁰
3. In response to a request from any participant or beneficiary, the plan administrator must furnish without charge copies of statements the plan receives from the regulated financial institutions holding or issuing the plan's qualifying plan assets and evidence of any required fidelity bond.³¹

Administrators can use the following chart to determine whether their plan meets the requirements for the audit waiver.

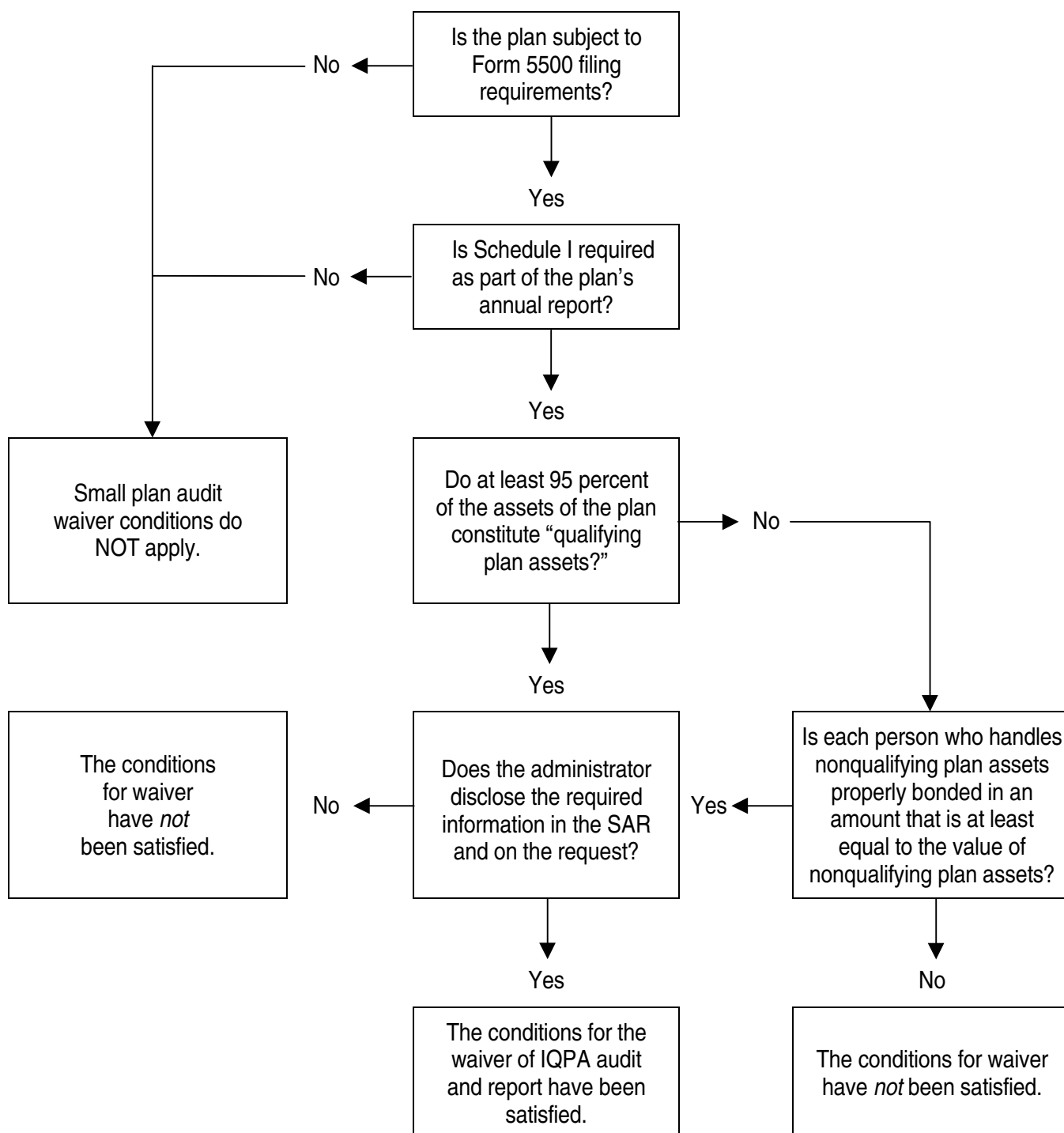
²⁷ DOL Reg. Section 2520.104.46(d)(4).

²⁸ DOL Reg. Section 2520.104.46(d)(1).

²⁹ DOL Reg. Section 2520.104.46(b)(1)(i)(A).

³⁰ DOL Reg. Section 2520.104.46(b)(1)(i)(B).

³¹ DOL Reg. Section 2520.104.46(b)(1)(i)(C).

Exhibit 21-1. Small Plan Audit Waiver Summary

Adapted from DOL Reg. §2520.104-41(c) and §2520.104-46(b)(1) and (d).

Qualifying Plan Assets

For the purposes of the audit waiver rules, *qualifying plan assets* are any of the following:³²

1. Any asset held by regulated financial institutions that is one of the following:
 - a. Banks or similar financial institutions, including trust companies, savings and loan associations, domestic building and loan associations, and credit unions
 - b. Insurance companies qualified to do business under the laws of a state
 - c. Organizations registered as broker-dealers under the Securities Exchange Act of 1934
 - d. Investment companies registered under the Investment Company Act of 1940
 - e. Any other organization authorized to act as a trustee for IRAs under IRC Section 408(n)
2. Shares issued by an investment company registered under the Investment Company Act of 1940 (e.g. mutual fund shares)
3. Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state
4. In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution describing the plan assets held or issued by the institution and the amount of such assets
5. Qualifying employer securities, as defined in ERISA Section 407(d)(5)
6. Participant loans meeting the requirements of ERISA Section 408(b)(1), whether or not they have been deemed distributed

If more than five percent of the plan's assets are nonqualifying and the plan obtains bonding and otherwise meets the waiver requirements, it can still claim the audit waiver.

All plan assets that must be reported on the Form 5500, Schedule I line 1a, column (b) for the end of the prior plan year must be included in the calculation of qualifying and non qualifying plan assets. The calculation must be made as soon as the information regarding the plan's assets at the close of the preceding plan year *practically* can be ascertained. This generally will be much sooner than the due date for filing the Form 5500 for that preceding plan year.

³² DOL Reg. Section 2520.104.46(b)(1)(ii).

In the initial plan year, the plan administrator may rely on estimates. The administrator should follow a similar method to the one described in 29 CFR 2580.412-15 for estimating the amount required for the ERISA Section 412 fidelity bond for an initial plan year.

Example. If a plan will be investing exclusively in assets that meet the definition of qualifying plan assets, for example, insurance contracts and mutual fund shares, bonding in addition to that required under ERISA Section 412 would not be necessary to meet the first condition for claiming the audit waiver.

If a new plan is initially funded through the transfer of assets from a predecessor plan, the percentage of qualifying plan assets is determined by treating the new plan as not having a preceding reporting year. The assets actually transferred from the predecessor plan are used to determine whether the new plan meets the 95-percent percentage condition for qualifying plan assets.

Account Type Requirements

The type of account the plan has with a regulated financial institution must generally be a trust or custodial account.³³

Plan assets held in bank custodial, common or collective trust, or separate trust accounts, for example, are qualifying plan assets. In addition, securities held by a broker-dealer for the plan in an omnibus account are qualifying plan assets. Checking and savings accounts that create a debtor-creditor relationship between the plan and the bank are also qualifying plan assets for purposes of the audit waiver conditions.

Example. The Thrifty Plan stores plan assets in a safe deposit box with a bank with three gold keys. Plan assets stored in a safe deposit box would not be treated as qualifying plan assets.

Assets in Individual Participant Accounts

Assets in individual participant accounts can be treated as qualifying plan assets if the individual account statements from the regulated financial institutions are mailed by affiliates of the regulated financial institutions, other unaffiliated service providers, or the plan administrator. However, the account statements must be statements of the regulated financial institution, but the institution's regular distribution systems may be used to transmit the statements to participants and beneficiaries.³⁴

³³ DOL Reg. Section 2520.104.46(b)(1)(ii)(C).

³⁴ DOL Reg. Section 2520.104.46(b)(1)(ii)(F).

Example. A statement prepared by the XYZ regulated financial institution, on the XYZ's letterhead, including contact information that a participant could use to confirm the accuracy of the information in the statement with XYZ, could be given to the plan administrator for distribution to the plan participants and beneficiaries. However, a statement prepared by the plan administrator, even if based on data from the regulated financial institution, would not meet the audit waiver condition.

Fidelity Bond for Nonqualifying Assets

Persons that handle nonqualifying assets must be covered by a fidelity bond or bonds that meet the requirements of ERISA Section 412, except that the bond amount must be at least equal to 100 percent of the value the nonqualifying plan assets the person handles. Persons handling nonqualifying plan assets can rely on normal rules and exemptions under ERISA Section 412 in complying with the audit waiver's enhanced bonding requirement.³⁵

Example. If the only nonqualifying assets that a person handles are not required to be covered under a standard ERISA Section 412 bond,³⁶ that person would not need to be covered under an enhanced bond for a plan to be eligible for the audit waiver.

If the plan has more than 5 percent of its assets in nonqualifying plan assets, the enhanced bond must cover all the nonqualifying assets not only those in excess of the 5-percent threshold. The person handling the nonqualifying plan assets can obtain his or her own bond. Also, a company providing services to the plan can obtain a bond covering itself and its employees that handle nonqualifying plan assets. The bond has to meet the requirements under ERISA Section 412, such as the requirements that the plan be named as an insured, that the bond not include a deductible or similar feature, and that the bonding company be on the Treasury Circular 570 list of approved surety companies.³⁷

ERISA provides that persons that handle plan funds or other property generally must be covered by a fidelity bond in an amount no less than 10 percent of the amount of funds the person handles, and that, in no case, shall such bond be less than \$1,000 nor is it required to be more than \$500,000.³⁸ In some cases, 100 percent of the value of nonqualifying plan assets may be less than 10 percent of the value of all of the plan funds a person handles. Under those circumstances, the ERISA Section 412 bond covering the person will satisfy the audit waiver condition because the amount of the bond will be at least equal to 100 percent of the nonqualifying plan assets handled by that individual.

³⁵ DOL Reg. Section 2520.104.46(b)(1)(i)(A)(2).

³⁶ For example, employer and employee contribution receivables described in DOL Reg. Section 2580.412-5.

³⁷ See <http://www.fms.treas.gov/c570/c570.html>.

³⁸ ERISA Section 412.

Example. Candace handles a total of \$1 million in plan funds, but only \$50,000 are nonqualifying plan assets. In that case, the ERISA Section 412 bond covering Candace should be equal to or greater than \$100,000, which would be more than the value of the nonqualifying assets Candace person handles. For that person, the ERISA Section 412 bond would also satisfy the audit waiver enhanced bonding requirement. Even if the amount of an existing ERISA Section 412 bond is insufficient to meet the audit waiver requirement, plan administrators may want to consider increasing the coverage under the ERISA Section 412 bond rather than getting a new fidelity bond.

Summary Annual Report Disclosures

A plan administrator must include the following additional information in the SAR furnished to participants and beneficiaries to be eligible for the small pension plan audit waiver:³⁹

1. Except as noted below, the name of each regulated financial institution holding or issuing qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year
2. The name(s) of the surety company issuing enhanced fidelity bonding, if the plan has more than five percent of its assets in nonqualifying plan assets
3. A notice indicating that participants and beneficiaries may, upon request and without charge, examine or receive from the plan copies of evidence of the required bond and copies of statements from the regulated financial institutions describing the qualifying plan assets
4. A disclosure stating that participants and beneficiaries should contact the DOL's Employee Benefits Security Administration (EBSA) Regional Office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond.

The enhanced SAR disclosure is not required for the following qualifying plan assets:

1. Qualifying employer securities as defined in Section 407(d)(5) of ERISA and the regulations issued thereunder
2. Participant loans meeting ERISA Section 408(b)(1) and the regulations issued thereunder
3. In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control provided the participant or beneficiary is furnished, at least annually, a statement

³⁹ DOL Reg. Section 2520.104.46(c)(2)-(3).

from an eligible regulated financial institution describing the assets held or issued by the institution and the amount of such assets.

Even if 95 percent of the plan's assets are qualifying plan assets, to be eligible for the audit waiver, the SAR must include the required information on the regulated financial institutions holding or issuing the plan's qualifying plan assets.

Model Language

The regulations do not require that model language be used for the required enhanced SAR disclosures. As long as the SAR includes the required information, it will satisfy the audit waiver condition. The following language may assist administrators in composing SAR disclosures for their plans that would satisfy the regulation. Plan administrators will need to modify the notice to omit bonding or other information that is not applicable to their plan:

The U.S. Department of Labor's regulations require that an independent qualified public accountant audit the plan's financial statements unless certain conditions are met for the audit requirement to be waived. This plan met the audit waiver conditions for *[insert year]* and therefore has not had an audit performed. Instead, the following information is provided to assist you in verifying that the assets reported in the Form 5500 were actually held by the plan.

At the end of the *[insert year]* plan year, the plan had (include separate entries for each regulated financial institution holding or issuing qualifying plan assets):

[Set forth amounts and names of institutions as applicable]

[Insert dollar amount] in assets held by *[Insert name of bank]*,

[Insert dollar amount] in securities held by *[Insert name of registered broker-dealer]*,

[Insert dollar amount] in shares issued by *[Insert name of registered investment company]*,

[Insert dollar amount] in investment or annuity contract issued by *[Insert name of insurance company]*

The plan receives year-end statements from these regulated financial institutions that confirm the above information. *[Insert as applicable: The remainder of the plan's assets were (1) qualifying employer securities, (2) loans to participants, (3) held in individual participant accounts with investments directed by participants and beneficiaries and with account statements from regulated financial institutions furnished to the participant or beneficiary at least annually, or (4) other assets covered by a fidelity bond at least equal to the value of the assets and issued by an approved surety company.]*

Plan participants and beneficiaries have a right, on request and free of charge, to get copies of the financial institution year-end statements and evidence of the fidelity bond. If you want to examine or get copies of the

financial institution year-end statements or evidence of the fidelity bond, please contact [insert mailing address and any other available way to request copies such as e-mail and phone number].

If you are unable to obtain or examine copies of the regulated financial institution statements or evidence of the fidelity bond, you may contact the regional office of the U.S. Department of Labor's Employee Benefits Security Administration for assistance by calling toll-free (866) 444-3272. A listing of EBSA regional offices can be found at www.dol.gov/ebsa. General information regarding the audit waiver conditions applicable to the plan can be found on the U.S. Department of Labor Website at www.dol.gov/ebsa under the heading, "Frequently Asked Questions."

Exhibit 21-2. Form 5500 Reporting Requirements

Certain employee benefit plans are exempt from the annual reporting requirements or are eligible for limited reporting options. The major classes of plans exempt from filing an annual report or eligible for limited reporting are described in the Form 5500 instructions.

The Form 5500 filed by plan administrators and GIAs are due by the last day of the 7th calendar month after the end of the plan or GIA year (not to exceed 12 months in length). See the Form 5500 instructions for information on extensions. The Form 5500 filed by DFEs other than GIAs are due no later than 9½ months after the end of the DFE year.

The Quick Reference Chart that follows describes the basic filing requirements for small plans, large plans, and DFEs. Check the EFAST Internet site at www.efast.dol.gov and the latest Form 5500 instructions for information on who is required to file, how to complete the forms, when to file, EFAST approved software, and electronic filing options.

EBSA, in conjunction with the Internal Revenue Service (IRS) and the PBGC, publishes the Form 5500 Annual Return/Report forms used by plan administrators to satisfy various annual reporting obligations under ERISA and the Internal Revenue Code (Code). The Form 5500 is filed and processed under the ERISA Filing Acceptance System (EFAST). There are two formats for filing the Form 5500.

The first format, "machine print," is completed using computer software from EFAST-approved vendors and can be filed electronically or by mail, including certain private delivery services. The other format, "hand print," may be completed by typewriter, by hand, or by using computer software from EFAST-approved vendors, and may be filed only by mail, including certain private delivery services.

The Form 5500 filing requirements vary according to the type of filer. There are three general types of filers: small plans (generally plans with fewer than 100 participants as of the beginning of the plan year); large plans (generally plans with 100 or more participants as of the beginning of the plan year); and direct filing entities (DFEs). DFEs are trusts, accounts, and other investment or insurance arrangements that plans participate in and that are required to or allowed to file the Form 5500 directly with EBSA. These investment and insurance arrangements include master trust investment accounts (MTIAs), common/collective trusts (CCTs), pooled separate accounts (PSAs), 103-12 investment entities (103-12 IEs), and group insurance arrangements (GIAs). MTIAs are the only DFE for which the filing of the Form 5500 is mandatory. Employee benefit plans that participate in CCTs, PSAs, 103-12 IEs, and GIAs that file as DFEs are eligible for certain annual reporting relief.

The Quick Reference Chart that follows is adapted from Reporting and Disclosure Guide for Employee Benefit Plans, published by the Department of Labor Employee Benefits Security Administration (EBSA) and is available at www.dol.gov/ebsa.

Pension and Welfare Benefit Plan Quick Reference Chart: Form 5500, Schedules and Attachments ¹				
	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan
Form 5500	Must complete. ²	Must complete. ²	Must complete.	Must complete. ³
Schedule A - Insurance Information	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits ³ or investments.
Schedule B - Actuarial Information	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Not required.	Not required.
Schedule C - Service Provider Information	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Not required.	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Not required.
Schedule D - DFE/Participating Plan Information	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.
Schedule E - ESOP Annual Information	Must complete if ESOP.	Must complete if ESOP.	Not required.	Not required.
Schedule G - Financial Transaction Schedules	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ⁵	Not required.	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ^{5, 6}	Not required.
Schedule H - Large Plan and DFE Financial Information	Must complete. ^{2, 5}	Not required.	Must complete. ^{5, 7}	Not required.
Schedule I - Small Plan Financial Information	Not required.	Must complete. ²	Not required.	Must complete. ³
Schedule P - Annual Return of Fiduciary of Employee Benefit Trust	Must file to start running of statute of limitations under Code § 6501(a).	Must file to start running of statute of limitations under Code § 6501(a).	Not required.	Not required.

	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan
Schedule R - Retirement Plan Information	Must complete, unless exempt. ⁸	Must complete, unless exempt. ⁸	Not required.	Not required.
Schedule SSA - Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits	Must complete if plan had separated participants with deferred vested benefits to report.	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.
Schedule T - Qualified Pension Plan Coverage Information	Must complete if tax-qualified plan unless permitted to rely on coverage testing information for prior year.	Must complete if tax-qualified plan unless permitted to rely on coverage testing information for prior year.	Not required.	Not required.
Independent Qualified Public Accountant's Report	Must attach. ^{2, 9}	Not required unless Schedule I, line 4k, is checked "No." ⁹	Must attach. ^{7, 9}	Not required.

¹ This chart provides only general guidance and not all rules and requirements are reflected. Refer to specific Form 5500 instructions for complete information on filing requirements.

² Pension plans are exempt from filing any schedules and the independent qualified public accountant's report if the plan uses a Code section 403(b)(1) annuity and/or 403(b)(7) custodial account, or 408 individual retirement account or annuity as the sole funding vehicle for providing benefits. Pension benefit plans providing benefits exclusively through an insurance contract or contracts that are fully guaranteed and that meet all of the conditions of 29 CFR § 2520.104-44(b)(2) during the entire plan year are exempt from filing Schedule H, Schedule I, and the independent qualified public accountant's report.

³ Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR § 2520.104-20 are exempt from filing an annual report.

⁴ Must also complete if filed for a money purchase defined contribution plan required to amortize a waiver of the minimum funding requirements.

⁵ Must also complete schedules of assets and reportable (5 percent) transactions if Schedule H, lines 4i or 4j, are marked "yes," but use of computer scannable form is not required.

⁶ Must also complete to report any nonexempt transactions even if Schedule H is not required.

⁷ Unfunded, fully insured and combination unfunded/insured welfare plans covering 100 or more participants at the beginning of the plan year that meet the requirements of 29 CFR § 2520.104-44 are exempt from the accountant's report requirement and completing Schedule H.

⁸ Must complete if defined benefit plan or plan is otherwise subject to minimum funding requirements. Certain other pension plans also may be required to complete this schedule. See Schedule R instructions for further explanation.

⁹ For information on the requirements for deferring an accountant's report pursuant to 29 CFR § 2520.104-50 in connection with a short plan year of 7 months or less and the contents of the required explanatory statement, see the Form 5500 instructions.

Chapter 22

ERISA Fiduciary Considerations

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ERISA Fiduciary Considerations

The rules relating to fiduciary conduct under the Employee Retirement Income Security Act of 1974, as amended (ERISA), prohibited transactions, payroll deduction plans, and investment-related information are discussed in this chapter. The chapter also includes a section with information about the Department of Labor's (DOL's) reporting and disclosure requirements under ERISA.

ERISA Coverage

Under Section 4(a) of ERISA, the only employee benefit plans subject to Title I of ERISA (regarding the protection of employee benefit rights) are those within the meaning of ERISA Section 3(3), provided such a plan is established or maintained by an employer engaged in commerce or in any industry or activity affecting commerce, by an employee organization or organization representing employees engaged in commerce or in any activity affecting commerce, or by both.

The term *employee benefit plan* includes employee pension-benefit plan.¹ Most simplified employee pension plans (SEP) and salary-reduction or elective SEP (SARSEP) are employee benefit plans under ERISA; however, many exclusions and exceptions apply. Notwithstanding whether an IRA is a plan within the meaning of Title I of ERISA, the prohibited transaction provisions of Internal Revenue Code (IRC or the Code) Section 4975 are applicable to transactions in an IRA or IRA-based plan. For the most part, savings incentive match plans for employees (SIMPLE) IRA plans are subject to special rules. (See Chapter 3, "SIMPLE Plans.")

¹ ERISA Section 3(3).

Employee Pension-Benefit Plan

Section 3(2)(A) of Title I of ERISA defines the term *employee pension-benefit plan* as follows:

[A]ny plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program

- (i) provides retirement income to employees, or
- (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

Plans without employees are not covered under Title I of ERISA.² Thus, for purposes of Title I, the term *employee-benefit plan* does not include any plan, fund, or program under which only a sole proprietor or only partners are participants covered under the plan. An individual and his or her spouse will not be deemed to be employees with respect to a trade or business, whether incorporated or unincorporated, that is wholly owned by the individual or by the individual and his or her spouse, and a partner in a partnership and his or her spouse will not be deemed to be employees with respect to the partnership. It is unclear, however, whether a limited liability company that is treated as a partnership for tax purposes and that has no common-law employees is excluded from coverage under Title I.

Example. Greg establishes a SEP for his sole proprietorship. Greg and his wife, Candy, are the SEP's only participants. A third employee is ineligible to participate for the current plan year. Greg causes his SEP IRA trustee to unwittingly purchase a piece of real estate as an investment for the IRA that Greg indirectly owns. Although the plan is exempt from Title I of ERISA, the transaction is, nonetheless, a prohibited transaction under IRC Section 4975.³

Reversions

Generally, the assets of an employee pension-benefit plan may never inure to the benefit of any employer.⁴

² DOL Reg. Section 2510.3-3.

³ IRC Sections 4975(e).

⁴ ERISA Section 403(c).

Prohibited Transactions and Related Definitions

For purposes of the prohibited transaction rules, the term *plan* means a trust described in IRC Section 401(a) that forms a part of a qualified plan, or a plan described in IRC Section 403(a) exempt from tax under IRC Section 501(a), and an IRA.⁵

A prohibited transaction includes any direct or indirect:

- Sale, exchange, or lease of any property between a plan and a disqualified person;
- Loan of money or other extension of credit between a plan and a disqualified person;
- Provision of goods, services, or facilities between a plan and a disqualified person;
- Transfer to or use by or for the benefit of a disqualified person of the income or assets of a plan;
- Act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in his or her own interest or for his or her own account; or
- Receipt of any consideration for his or her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.⁶

Example. Tar Corporation established a SEP for its 750 employees and makes contributions into a group (employer) IRA trust under IRC Section 408(c). Tar, a fiduciary, retains his daughter Marilyn to provide much-needed administrative services to the plan's trust for a fee. Marilyn's provision of services to the trust is a prohibited transaction. The prohibited transaction may, however, be exempt from the excise tax if it meets certain conditions. As a fiduciary, Tar's action causing the plan to pay a fee to his daughter is a separate prohibited transaction, which would not be exempt.⁷

⁵ IRC Section 4975(e)(1); ERISA Section 3.

⁶ IRC Section 4975(c); ERISA Section 406; see DOL Interpretive Bull 94-3, 59 FR 66735 (1994) (in-kind contributions to satisfy statutory or contractual funding obligations); *Marshall v. Snyder*, 430 F Supp 1224 (E.D.N.Y. 1977), aff'd in part and remanded in part, 572 F 2d 894 (2d Cir 1978) (furnishing of goods, services, or facilities); *Leigh v. Engle*, 727 F 2d 113 (7th Cir 1984) (self-dealing); *New York State Teamsters Council Health & Hospital Fund v. Estate of De Perno*, 816 F Supp 138 (N.D.N.Y. 1993), aff'd in part and remanded, 18 F 3d 179 (2d Cir 1994) (self-dealing, financial loss to trust fund not necessary); see, too, DOL Adv. Ops. 86-01A, 88-03A, 89-089A, 93-06A (direct expenses of salary and related cost of employees that work on plans).

⁷ IRC Section 4975(d)(2); I.R.M. 4.72.11.3.5, Fiduciary Self-Dealing; see David A. Pratt, "Focus on Prohibited Transactions-Part I," 10 *J Pension Ben* 2 (Winter 2003), which outlines transactions that are prohibited by ERISA and the transactions that are exempt from ERISA prohibitions.

Note. The penalty for initial violations is 15 percent of the amount involved for prohibited transactions occurring after August 5, 1997. If the transaction is not corrected, there is a second-tier excise tax of 100 percent of the amount involved.⁸

Waivers

The Secretary of the Treasury has established a procedure under which a conditional or unconditional exemption from all or part of the prohibited transaction rules may be granted to any disqualified person or transaction or to any class of disqualified persons or transactions.⁹ The Secretary of Labor generally may not grant an exemption unless he or she finds that such an exemption is:

1. Administratively feasible
2. In the interests of the plan and its participants and beneficiaries
3. Protective of the rights of participants and beneficiaries of the plan¹⁰

Disqualified Person

For purposes of the Code, the term *disqualified person* refers to any of the following:

1. A fiduciary
2. A person providing services to a plan
3. An employer, any of whose employees are covered by a plan
4. An employee organization any of whose members are covered by a plan
5. An owner, direct or indirect, of 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation, the capital interest or the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in items 3 or 4
6. A member of the family (spouse, ancestor, lineal descendant, or any spouse of a lineal descendant) of a person described in items 1, 2, 3, or 5

⁸ IRC Section 4975(a); SBJPA Section 1453(a); TRA 97 Section 1074(a).

⁹ DOL Reg. Sections 2570.30-2570.52.

¹⁰ IRC Section 4975(c)(2); Reorg. Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct 17, 1978) (transferring the authority of the Secretary of the Treasury to issue rulings under IRC Section 4975 to the Secretary of Labor) The Secretary of the Treasury has delegated this authority, along with most other responsibilities under ERISA, to the Assistant Secretary for the EBSA. [Sec of Labor's Order 1-87, 52 FR 13139 (April 28, 1987).

7. A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation, the capital interest or profits interest of such partnership, or the beneficial interest of such trust or estate is owned directly or indirectly or held by a person described in items 1, 2, 3, 4, or 5
8. An officer or director (or an individual having powers or responsibilities similar to those of an officer or a director), a 10 percent or more shareholder, or a highly compensated employee (HCE), that is, one earning 10 percent or more of the yearly wages of an employer, of a person described in items 3, 4, 5, or 7
9. A 10 percent or more (in capital or profits) partner or joint venturer of a person described in items 3, 4, 5, or 7

Note. ERISA prohibits certain transactions between a plan and a party in interest. Under the Code, the term *disqualified person* is used instead of party in interest and it is defined slightly differently.¹¹

Party in Interest

For purposes of ERISA, the term *party in interest* refers to any of the following:

1. Any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of an employee benefit plan
2. A person providing services to a plan¹²
3. An employer, any of whose employees are covered by a plan
4. An employee organization, any of whose members are covered by a plan
5. An owner, direct or indirect, of 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation, the capital interest or the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in items 3 or 4
6. A relative (spouse, ancestor, lineal descendant, or any spouse of a lineal descendant) of any person described in items 1, 2, 3, or 5
7. A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of the combined voting power of all classes of stock en-

¹¹ IRC Section 4975(e)(2).

¹² See *Harris Trust and Savings Bank v. Solomon Smith Barney*, 530 US 238 (2000) (broker-dealer providing nondiscretionary equity trades to plan automatically classified as party in interest).

titled to vote or the total value of shares of all classes of stock of such corporation, the capital interest or profits interest of such partnership, or the beneficial interest of such trust or estate is owned directly or indirectly or held by persons described in items 1, 2, 3, 4, or 5

8. An employee, an officer or director (or an individual having powers or responsibilities similar to those of an officer or a director), a 10 percent or more shareholder, or a HCE (earning 10 percent or more of the yearly wages of an employer) of a person described in items 2, 3, 4, or 5
9. A 10 percent or more (in capital or profits) partner or joint venturer of a person described in items 2, 3, 4, 5, or 7¹³

Fiduciary

The term *fiduciary* refers to any person who can do any of the following:

1. Exercise any discretionary authority or discretionary control respecting management of a plan or exercise any authority or control respecting management or disposition of its assets.
2. Render investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of a plan, or has any authority or responsibility to do so.
3. Assume any discretionary authority or discretionary responsibility in the administration of a plan.

The administration of a plan (including a SEP arrangement) is the responsibility of the plan administrator. Therefore, under ERISA, the plan administrator is a fiduciary and thus is subject to the fiduciary duties imposed by ERISA.

Note. A person that is designated by a named fiduciary to carry out fiduciary responsibilities (other than trustee responsibilities under the plan) is treated as a fiduciary.

¹³ ERISA Section 3(14).

Practice Pointer: Accountants, attorneys, actuaries, insurance agents, and consultants who provide services to a plan are not considered fiduciaries unless they exercise discretionary authority or control over the management or administration of the plan or the assets of the plan, even if such activities are unauthorized.¹⁴

Note. Accountants, attorneys, actuaries, insurance agents, and consultants are not fiduciaries. Nevertheless, they may be liable to a plan under traditional theories of malpractice.

Investment-Related Information

An employer is permitted but not required to educate its employees about investment principles, financial planning, and retirement; however, the employer must be cautious when it does so. Providing investment-related information may be considered the rendering of investment advice and could raise questions about fiduciary conduct under ERISA in plans that permit participants to direct their own investments.¹⁵

The Employee Benefits Security Administration (EBSA), formerly the Pension and Welfare Benefits Administration (PWBA), has guidance designed to help plan sponsors and service providers educate participants about plan investments without providing investment advice; the guidance applies to plans that permit participants to direct their own investments. There are several safe harbors or types of information and materials that may be provided to participants without giving investment advice under ERISA, including the following:

1. *Plan information.* This means information about plan participation; the benefits of increasing plan contributions; the impact of preretirement withdrawals on retirement income; the terms and operation of the plan; and investment alternatives, including a description of investment objectives and philosophies, risk and return characteristics, historical return information, and investment prospectuses.
2. *General financial and investment information.* This means information about general financial and investment concepts, historic differences in rates of return between different asset classes, the effects of inflation. In addition, their information encompasses estimating fu-

¹⁴ ERISA Section 3(21)(A); PWBA Interpretive Bulletin 75-5, Q&A D-1; DOL Reg. Section 2509.75-5, Q&A D-1; *John Hancock Mut Life Ins Co v. Harris Trust & Sav Bank*, 510 US 86 (1993); *Kaniewski v. Equitable Life Assurance Soc'y*, No. 88-01296, 1993 WL 88200 (6th Cir Mar 26, 1993) (unpublished opinion); *Kyle Rys Inc v. Pacific Admin Servs Inc*, 990 F2d 513 (9th Cir 1993) (third-party administrator); *Nieto v. Ecker*, 845 F2d 868 (9th Cir 1988) (attorneys); *Olson v. EF Hutton & Co*, 957 F2d 622 (8th Cir 1992); *Procacci v. Drexel Burnham Lambert*, No. 89-0555 (ED Pa 1989); *Painters of Phila Dist Council No. 21 Welfare Fund v. Price Waterhouse*, 879 F2d 1146 (3d Cir 1989)(accountants); *Pappas v. Buck Consultants Inc*, 923 F2d 531 (7th Cir 1991) (actuaries); *Schloegel v. Boswell*, 994 F2d 266 (7th Cir 1993)(insurance agent).

¹⁵ ERISA Section 3(21) (A)(ii); PWBA Interpretive Bulletin 96-1; DOL Reg. Sections 2509.96-1, 2510.3-21(c).

ture retirement income needs, determining investment time horizons, and assessing risk tolerance.

3. *Asset allocation models.* This means information and materials such as pie charts, graphs, or case studies that provide models of asset allocation portfolios for hypothetical individuals with different time horizons and risk profiles.

Asset allocation models identifying a specific investment alternative under the plan must provide an accompanying statement indicating that other investment alternatives with similar risk and return characteristics may be available under the plan. The statement must also specify how to obtain information on those investment alternatives. It is not necessary to specifically describe other investment alternatives with similar risk and return characteristics. Asset allocation models may take into account a participant's nonplan assets, income, investments, and other information, and service providers may assist individual participants in developing asset allocation models.

4. *Interactive investment materials.* Questionnaires, worksheets, software, and similar materials that provide a participant or a beneficiary with the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income.

Caution: *Despite the safe harbors, an employer's designation of a service provider to provide investment educational services or investment advice is an exercise of discretionary authority and, thus, is a fiduciary act that could result in fiduciary liability for the employer.*

Payroll Deduction IRA

An IRA into which an employee is allowed to make contributions with after-tax dollars is called a *payroll deduction IRA*. An IRA used in connection with an employer's SEP arrangement may also be used in connection with a payroll deduction IRA. Contributions to the payroll deduction IRA are subject to the traditional IRA limits under IRC Sections 219 and 408 (generally 100 percent of compensation or \$3,000 if less, plus catch-up contributions for 2004). An employer that establishes a payroll deduction IRA will be treated as maintaining an ERISA plan, unless certain conditions are satisfied.

DOL regulations provide a safe harbor under which IRAs will not be considered to be pension plans when the conditions of the regulation are satisfied. Thus, with few constraints, employees may be provided an additional opportunity for saving for retirement. The safe-harbor rules require that:

1. No contributions are made by the employer or employee association.
2. Participation must be completely voluntary for employees or members.

3. The sole involvement of the employer or employee organization is without endorsement to permit the sponsor to publicize the program to employees or members, to collect contributions through payroll deductions or dues checkoffs, and to remit them to the sponsor.
4. The employer or employee organization receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions or dues checkoffs.¹⁶

An employer may forward contributions made under a payroll deduction IRA program into the same IRAs that are used to receive employer SEP contributions. Note the following definitions, which influence how deductions are perceived:

- *Endorsement.* If the employer does not maintain neutrality with respect to the sponsor it selects, the employer is thought to have *endorsed* the sponsor. For purposes of the regulations, if an employer maintains neutrality with respect to the sponsor in its communications with its employees, the employer will not be considered to *endorse* an IRA payroll deduction program.¹⁷
- *Neutrality.* An employer may demonstrate its *neutrality* with respect to a sponsor in a variety of ways, including but not limited to ensuring that materials distributed to employees in connection with a payroll deduction program clearly and prominently state, in language reasonably calculated to be understood by the average employee, that:
 - The IRA payroll deduction program is completely voluntary.
 - The employer does not endorse or recommend either the sponsor or the funding media.
 - Other IRA funding media are available to employees outside of the payroll deduction program.
 - An IRA may not be appropriate for all individuals.
 - The tax consequences of contributing to an IRA through the payroll deduction program are generally the same as the consequences of contributing to an IRA outside of the program.

The employer would not be considered neutral to the extent that the materials distributed to the employees identified either of the following:

- The funding medium has, as one of its purposes, investing in the securities of the employer or its affiliates.
- The funding medium has significant investments in securities of the employer or its affiliates.

¹⁶ DOL Reg. Section 2510.3-2(d).

¹⁷ DOL Reg. Section 2509.99-1(c)(1).

If the program resulted from an agreement between the employer and an employee organization, the following would indicate that the employee organization's involvement in the program is less than neutral. Informational materials that identified the funding medium as having, as one of its purposes, investing in a vehicle that is designed to benefit an employee organization by providing more jobs for its members, or loans to its members, or similar direct benefits (or the funding medium's actual investments in any such investment vehicles).¹⁸

- *Special SEP and SIMPLE Rule.* An employer that selects, recommends, or in any other way influences employees to choose a particular IRA or type of IRA into which contributions under a SEP or SIMPLE IRA plan are to be made is likely to be treated as a fiduciary. If, however, employees are given the opportunity to exercise control over assets in their IRAs and a broad range of investment alternatives is available, the employer will not be deemed a fiduciary. If the employer is treated as a fiduciary, it must (like all fiduciaries under ERISA) carry out its duties with the care, skill, prudence, and diligence that a prudent person acting in a like capacity would use under conditions prevailing at the time. A fiduciary must also conduct all transactions solely in the interests of plan participants and their beneficiaries.¹⁹
- *Reasonable Compensation.* Reasonable compensation does not include any profit to the employer. Payments that an employer receives from a IRA sponsor for the employer's cost of operating the IRA payroll deduction program do constitute reasonable compensation to the extent that they constitute compensation for the actual costs of the program to the employer.

Example. The IRA sponsor agrees to make or to permit particular investments of IRA contributions in consideration for the employer's agreement to make a payroll deduction program available to its employees. Such an arrangement would exceed "reasonable compensation" for the services actually rendered by the employer in connection with the program.²⁰

Without converting the payroll deduction program into an ERISA-covered plan, an employer may:

1. Answer employees' specific inquiries about the mechanics of the IRA payroll deduction program and may refer other inquiries to the appropriate IRA sponsor.
2. Provide to employees informational materials written by the IRA sponsor describing the sponsor's IRA programs or addressing topics of general interest regarding investments and retirement savings, pro-

¹⁸ DOL Reg. Section 2509.99-1(c)(1), footnote 2.

¹⁹ ERISA Section 404(c); DOL Reg. Section 2550.404c-1.

²⁰ DOL Reg. Section 2509.99-1(f).

vided that the material does not itself suggest that the employer is other than neutral with respect to the IRA sponsor and its products.

3. Request that the IRA sponsor prepare such informational materials, and it may review such materials for appropriateness and completeness.²¹

Note. The fact that the employer's name or logo is displayed in the informational materials in connection with describing the payroll deduction program would not in and of itself suggest that the employer has endorsed the IRA sponsor or its products, provided that the specific context and surrounding facts and circumstances make clear to the employees that the employer's involvement is limited to facilitating employee contributions through payroll deductions.

An employer may limit the number of IRA trustees or custodians to which its employees may make payroll deduction contributions, provided that any limitations on or costs or assessments associated with an employee's ability to transfer or roll over IRA contributions to another IRA trustee or custodian are fully disclosed in advance of the employee's decision to participate in the program. Also, an employer may violate the limitations of such a program if the employer negotiates with an IRA trustee or custodian and thereby obtains special terms and conditions for its employees that are not generally available to similar purchasers of the IRA. The employer's involvement in the IRA program would also be in violation of the limitations if the employer exercises any influence over the investments made or permitted by the IRA sponsor.²²

Fees of Payroll Deduction IRA Sponsor

The employer may pay any fee the IRA sponsor imposes on employers for services the sponsor provides in connection with the establishment and maintenance of the payroll deduction process itself. The employer may also assume the internal costs (e.g., for overhead, bookkeeping, and so on) of implementing and maintaining the payroll deduction program without reimbursement from either employees or the IRA sponsor.²³

Caution: *If, in connection with operating an IRA payroll deduction program, an employer pays any administrative, investment management, or other fee that the IRA sponsor would require employees to pay for establishing or maintaining the IRA, the employer would fall outside the safe harbor and, as a result, may be considered to have established an ERISA-covered plan.*

An employer that offers IRAs in the normal course of its business to the general public or that is an affiliate of an IRA sponsor may provide

²¹ DOL Reg. Section 2509.99-1(c)(2).

²² DOL Reg. Section 2509.99-1(d).

²³ DOL Reg. Section 2509.99-1(e).

*its employees with the opportunity to make contributions to IRAs sponsored by the employer or the affiliate through a payroll deduction program as long as special rules are satisfied.*²⁴

Payroll Deduction Roth IRAs

It is been the DOL's long-held view that an employer who provides employees with the opportunity for making contributions to an IRA through payroll deductions does not thereby establish a *pension plan* within the meaning of ERISA Section 3(2)(A). Although a Roth IRA is not a traditional IRA, in the authors' opinion, the DOL's view would apply equally to a payroll deduction Roth IRA program.²⁵

It should be noted that an employer may encourage participation by employees by providing general information on the payroll deduction program and other educational materials that explain the prudence of retirement savings, including the advantages of contributing to an IRA, without thereby converting the wage contribution withholding program to an ERISA-covered plan.

Practice Pointer: The employer must make it clear that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's retirement savings.²⁶

Reporting and Disclosure Guide for Employee Benefit Plans

The U. S. DOL's EBSA has issued a booklet entitled *Reporting and Disclosure Guide for Employee Benefit Plans*. The guide will assist employers, plan sponsors, service providers and other plan officials in meeting their reporting and disclosure obligations under ERISA.

The guide is designed to help plan officials understand the scope of ERISA's basic reporting and disclosure rules.

The booklet includes information on group health plan disclosure requirements under Part 7 of ERISA and the new blackout period notice, which requires 401(k) and other individual account pension plans to provide advance notice when participants' rights are suspended for direct investments, loans, or distributions.

²⁴ See, DOL Reg. Section 2509.99.99-1(g).

²⁵ See, IRS Announcement 99-2 (1999-1 CB 305).

²⁶ DOL Reg. Section 2509.99-1(c)(1).

Prepared with the assistance of the Pension Benefit Guaranty Corporation (PBGC), the guide provides information and overview charts on:

- Basic ERISA disclosures that retirement, group health and other welfare benefit plans must furnish to participants and beneficiaries
- PBGC reporting and disclosure requirements for single-employer defined-benefit pension plans
- Annual reporting requirements for the Form 5500 and Form M-1

The guide also contains a list of EBSA and PBGC resources, including the agencies' Internet Web sites that contain laws, regulations, and other guidance relating to ERISA's reporting and disclosure requirements. The publication is available by calling toll-free, 1-866-444-EBSA (3272) or online at www.dol.gov/ebsa under Publications (<http://www.dol.gov/ebsa/pdf/rdguide.pdf>).

Chapter 23

Uniformed Services Employment and Re-Employment Rights

By STEPHEN J. MOGILA, ESQ.

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Uniformed Services Employment and Re-Employment Rights

BY STEPHEN J. MOGILA, ESQ.

As a result of the military conflicts in Iraq and Afghanistan, many employers have employees who are now returning to employment after serving in the military. A number were reservists called to active and/or training duty; others volunteered to serve in the U.S. armed forces¹ (military employees). In this regard, an employer who sponsors a tax-qualified retirement plan must extend certain pension benefits and protections to military employees pursuant to the rules set forth under the Uniformed Services Employment and Re-employment Rights Act of 1994 (USERRA).²

In general, the benefits and protections afforded under USERRA are designed to prohibit employment discrimination against military employees in order to encourage such employees to continue their service with the military. Such protections apply ubiquitously to all employers, including governmental, church, private-sector, small employers, and successor employers (who acquired another company via a merger, acquisition, or consolidation). This chapter discusses the pension and healthcare benefits and protections afforded to military employees under USERRA.

¹ The U.S. armed forces include the Army, the Navy, the Air Force, the Marines, the Coast Guard, and the Commissioned Corps of the Public Health Services.

² On October 13, 1994, President Clinton signed USERRA into law.

Overview of USERRA

USERRA was signed into law on October 13, 1994. USERRA clarifies and strengthens the Veterans' Reemployment Rights (VRR) Statute.³ USERRA is intended to minimize the disadvantages to an individual that result when that person needs to be absent from his or her civilian employment to serve in this country's *uniformed services*. USERRA makes major improvements in protecting servicemember rights and benefits by clarifying the law and improving enforcement mechanisms. It also provides employees with Department of Labor (DOL) assistance in processing claims. Specifically, USERRA expands the cumulative length of time that an individual may be absent from work for uniformed services' duty and retain reemployment rights. The law is intended to encourage noncareer uniformed service so that America can enjoy the protection of those services, staffed by qualified people, while maintaining a balance with the needs of private and public employers who also depend on these same individuals.

USERRA potentially covers every individual in the country who serves in or has served in the uniformed services and applies to all employers in the public and private sectors, including federal employers. The law seeks to ensure that those who serve their country can retain their civilian employment and benefit, and can seek employment free from discrimination because of their service. USERRA provides enhanced protection for disabled veterans, requiring employers to make reasonable efforts to accommodate the disability.

USERRA is administered by the DOL, through the Veterans' Employment and Training Service (VETS). VETS provides assistance to those persons experiencing service-connected problems with their civilian employment and provides information about the Act to employers. VETS also assists veterans who have questions regarding Veterans' Preference.⁴

Pension Benefits Under USERRA

In order for a military employee to receive the protections extended under USERRA, such employee must comply with certain notice and re-employment requirements. In this regard, a military employee will receive the benefits afforded under USERRA if:

1. Such employee provided advanced notice of his or her intention to serve in the military to his or her employer.

³ The Act itself can be found in the United States Code at Chapter 43, Part III, Title 38. The Department of Labor has issued a memorandum that clarifies its position on the rights of returning service members to family and medical leave under the Uniformed Services Employment and Reemployment Rights Act (USERRA). That memorandum is available at <http://www.dol.gov/vets/media/fmlarights.pdf>.

⁴ For more information, please visit the Veterans' Preference Advisor. Or contact a local VETS office. See <http://www.dol.gov/vets/aboutvets/contacts/main.htm>.

2. The military employee at issue was released from military duty under honorable or nonpunitive conditions.
3. The cumulative period of such employee's military leave of absence from employment did not exceed five years.
4. Such employee reported to work or applied for re-employment with his or her employer in a timely manner after the completion of his or her military service, namely, the *Qualification Requirements*.

Nevertheless, if re-employment with an employer would be impossible or unreasonable, or result in an undue hardship to the employer, then such employer is not obligated to rehire the military employee at issue. In addition, if the military employee's position with the employer was related to a temporary position with no reasonable expectation that such employment would continue indefinitely, then such employer is also not required to hire such military employee. In this regard, an employer is only required to extend the pension benefits as required under USERRA to a military employee who is actually re-employed by such employer. Therefore, an employer who sponsors a tax-qualified plan should determine whether a military employee has satisfied the abovementioned requirements in order to qualify for the USERRA benefits discussed below.⁵

Upon re-employment, if the terms of the plan provide for such benefits and/or contributions, an employer who sponsors such plan must ensure that a military employee who meets the qualification requirements receive:

1. Profit-sharing contribution(s) that would have been provided to such employee during his or her period of military service. The employer must fund such contributions within a period of time that is the lesser of three times the military employee's period of service or five years, commencing on the date that the military employee returns to employment with the employer (contribution period).⁶
2. The ability to make 401(k) elective deferral contributions that such employee was unable to make during his or her period of military service (make-up contributions).⁷ The military employee must make his or her make-up contributions before the end of the contribution period.
3. Matching contribution(s) equal to the amount that would have been provided to such military employee during his or her period of military

⁵ The application of the qualification requirements is beyond the scope of this article. As such, you should contact your legal and tax advisers to discuss the specific application of such rules if you should rehire a military employee.

⁶ For purposes of annual limitations on contributions, employer and employee contributions made for periods of military service are subject to the limitations applicable to the year in which the contribution relates and not the year in which such contributions are made. However, re-employed military employees are not entitled to missed allocations that result from any "forfeitures" or "lost earnings" on missed or late contributions that occurred during his or her period of qualified military service.

⁷ Actual deferral percentage (ADP) and actual contribution percentage (ACP) tests do not apply to these contributions either for the plan year to which they relate or the plan year in which they are actually made.

service in relation to the amount of the actual make-up contributions made by such employee during the contribution period.⁸

4. Credit for vesting purposes with regard to the period in which such military employee was performing qualified military service.
5. No break in service for the military employee for the purposes of determining eligibility or vesting under the terms of the plan at issue on account of his or her absence from employment due to qualified military service.
6. If permitted by the terms of the plan, the suspension of plan loan repayments with respect to the period during which the military employee performed qualified military services. Upon re-employment, the military employee at issue must resume loan repayments with the same or greater frequency with regard to the original amortization schedule for such loan. In addition, the re-employed military employee must repay the full loan with interest (including interest that accrued during qualified military leave) by the end of the maximum term of such loan, not including the period of time that such qualified military service was performed.

As indicated above, military employees may be entitled to substantial pension rights and benefits under USERRA. As a result, employers must remember to comply with the rights outlined above if a re-employed military employee meets the qualification requirements. A failure to provide the abovementioned rights to such military employee can jeopardize the tax-qualified status of the plan and result in a USERRA violation. The tax-qualified status of a plan can also be jeopardized if an employer:

1. Improperly affords the USERRA benefits to an employee who is not entitled to receive them, or
2. Provides greater benefits than permitted under USERRA to military employees entitled to receive such benefits.

Therefore, employers who sponsor a tax-qualified plan should review their pension policies and procedures in order to protect the tax-qualified status of the retirement plan at issue.

Healthcare and COBRA Benefits Under USERRA

Military employees are also entitled to purchase continued healthcare coverage under their employer's health plan during their period of military service.⁹

⁸ See footnotes 4 and 5.

⁹ Military employees, who are on active duty, are also eligible for healthcare coverage with the military's healthcare provider, which is such employee's primary coverage. If a military employee requires healthcare services that are not covered under the military's health plan, then the healthcare coverage provided under the employer's healthcare plan would constitute the military employee's primary healthcare coverage. However, with respect to a military employee's spouse or dependents, military healthcare coverage is secondary to other healthcare coverage (i.e. USERRA, COBRA, or an employer's healthcare coverage).

In this regard, an employer must continue to provide military employees and their dependents with healthcare coverage for a period up to 18 months. This coverage must be provided to a military employee regardless of whether the employer generally provides healthcare coverage during other leaves of absence, or the employer is subject to the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA). If military leave is less than 31 days, the employer must not charge a military employee more than the amount that is charged to its nonmilitary employees for the purposes of maintaining healthcare coverage under the employer's health plan. However, if military leave is 31 days or longer, then an employer may charge a military employee up to 102 percent of the cost of healthcare coverage as determined in accordance with the methods for determining premiums under COBRA.

In addition, COBRA integrates the abovementioned healthcare benefits under USERRA with the healthcare benefits afforded under COBRA. In this regard, the healthcare coverage provided under USERRA is treated as an alternative coverage as set forth under COBRA. As a result, the applicable COBRA notices and election rights must be provided to a military employee when he or she commences a military leave of absence because such leave constitutes a qualifying event under COBRA due to such employee's reduction of hours with the employer. If the employer is subject to COBRA, then the employer must offer the military employee with the ability to continue healthcare coverage under USERRA and COBRA. If the military employee at issue selects USERRA as the form of continuation healthcare coverage, then such person is not entitled to a COBRA election when their healthcare coverage ends under USERRA. If the military employee selects COBRA as the method of continuation healthcare coverage, then such person may not receive healthcare coverage under USERRA when their healthcare coverage ends under COBRA. Therefore, employers should provide military employees with the previously mentioned information along with the applicable COBRA materials at the time such employee commences a leave for military service.

Conclusion

With the prospect of military employees being called to serve in the military in Iraq, Afghanistan, or elsewhere, employers who employ such persons should review their pension and healthcare policies and procedures to ensure compliance under USERRA, maintain the tax-qualified status of the retirement plan at issue, and to accommodate their brave military employees.

Chapter 24

Missing Participants, Beneficiaries, and Alternate Payees

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Missing Participants, Beneficiaries, and Alternate Payees

Locating missing participants can be a costly and time-consuming effort. This chapter discusses various methods of locating missing participants, alternate payees, and beneficiaries. The Internal Revenue Service (IRS) and Social Security Administration (SSA) letter forwarding programs are discussed, as well as the assistance that can be provided by the Pension Benefit Guaranty Corporation (PBGC). Internet and private locator services are also discussed.

General Rules

As a general rule, plan administrators have a fiduciary duty under Employee Retirement Income Security Act of 1974, as amended (ERISA) to make reasonable efforts to locate all participants and/or alternate payees. The steps a fiduciary must take to locate lost participants or alternate payees generally fall under a facts-and-circumstances determination.

Currently, no regulations exist to guide a company on what to do if it cannot find a participant. Despite the lack of guidelines, a company should always be prepared to pay the participant if that participant appears again. If a plan is terminated and a missing participant appears at a later time, whether or not that participant's benefits can be reinstated is unclear.

If attempts to locate a participant or beneficiary are unsuccessful, the plan administrator can seek assistance from the IRS, or the SSA. Special rules apply to a plan covered (insured) by the PBGC. In addition, there are private firms that provide participant and beneficiary search services, and they are generally more effective—often 80 to 90 percent effective.¹ The IRS and SSA programs simply forward letters, and a missing participant who receives a let-

¹ Lee, "Tracking Down Missing Beneficiaries," 30 Pension World (Sept 1994) 35.

ter may or may not respond. The forwarding area may, in some cases, be limited to one region of the country.²

Note. A plan administrator who follows the appropriate plan procedures for locating a lost participant and/or alternate payee but is still unable to locate the individual will not violate his or her fiduciary duties by paying the benefits into an interest-bearing federally insured bank account opened in the individual's name. For an administrator to take advantage of this option, the payment must be permitted under the terms of the plan.

Missing Participant, Missing Beneficiary, or Alternate Payee

A missing participant, missing beneficiary, or missing alternate payee is a participant, beneficiary, or alternate payee who is eligible for a benefit distribution but cannot be located.

Plan Administrative Policy

The company or plan administrator should consider the adoption of a policy to locate a missing participant and/or alternate payees. The provisions of this policy should be stated in the plan and approved by the IRS. Consideration should be given to the following issues:

- The steps that will be taken to find missing participants
- What will be done with missing participants' accounts
- If and when the account value will be forfeited-after all reasonable efforts to locate the missing participants or alternate payee have been exhausted and proved unsuccessful

IRS Letter Forwarding Program

The IRS will forward letters for third-parties in order to serve humane purposes under its Letter Forwarding Program. IRS Policy Statement P-1-187 established this program, whereby the IRS will forward a letter to an unlocatable individual on behalf of a private individual, company, or government.³

Tax returns and return information are considered so confidential that an inquirer who activates the letter-forwarding service will not be informed of the disposition of the inquiry.⁴ Letters intended for individuals for whom the IRS

² Preamble, PBGC Reg. Pt. 4050, 60 Fed. Reg. 61740.

³ Rev. Proc. 94-22, 1994-1 CB 608.

⁴ IRC Section 6103.

has no current records and letters forwarded by IRS and then returned as undeliverable, are destroyed without informing the sender of the action taken.

Humane Purpose

A *humane purpose* might include an attempt to reunite family members or a qualified plan administrator's attempt to locate and pay a plan participant. The term does not include the reconstruction of a family tree or delivery of a letter seeking reparation.

Example. A qualified plan administrator is attempting to contact a missing participant in regard to the repayment of an overpayment distributed from the plan. The Letter Forwarding Program does not apply to locating a party to pending litigation or for service of process.

Letter Forwarding Procedure

The applicant must provide the IRS with the missing individual's Social Security number, along with other information regarding the search. The IRS will provide assistance in locating 50 or fewer individuals at no cost to the employer. The Letter Forwarding Program is comprised of two components. One involves forwarding letters to 49 or fewer individuals; the other involves forwarding letters to 50 or more individuals. Each possibility is discussed in the following sections.

Forwarding Letters to 49 or Fewer Individuals

Procedures for forwarding letters to 49 or fewer individuals within a 12-month period are found in IRS Policy Statement P-1-187. The procedures apply only under certain circumstances. For example, the program can be used if a person is seeking to notify a taxpayer that he or she is entitled to certain assets, for example, from a qualified pension, profit-sharing, or stock bonus plan that has been terminated and from which the taxpayer is entitled to a distribution of benefits. Requests for letter-forwarding assistance involving 49 or fewer participants and beneficiaries are sent to the disclosure officer at the IRS's district office nearest the requester. There is no charge for this service. The following instructions apply to an individual or organization requesting that the IRS forward letters on its behalf to 49 or fewer individuals within a 12-consecutive-month period:

- Prepare a cover letter. This cover letter should state why the assistance of the IRS is being sought, list the name(s), *correct* social security number(s), and (if available) last known address(es) of the individual(s) who cannot be located; and include the name and address of the person or organization to whom the IRS should send an acknowledgment letter.
- Enclosed with the cover letter, include a letter (three pages or less) directed to the individual(s) who cannot be located. This letter should:

- Advise the recipient of the reason for the letter.
- Include instructions as to what the recipient should do to contact the sender, if he or she decides to respond.
- Make clear that a response to the sender's letter is completely voluntary on the part of the recipient.
- A disclaimer statement. This statement should read as follows:

In accordance with current policy, the IRS has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding this letter. Your response to this letter is completely voluntary.

- A third-party individual or organization requesting the use of the IRS Letter Forwarding Program on behalf of another party that is actually holding assets for a missing taxpayer must:
 - State, in its cover letter to the IRS, that it is acting on behalf of that other party.
 - Present convincing documentation that he or she is acting as the authorized agent of an individual seeking to notify individuals who cannot otherwise be located that they are entitled to certain assets.

In the case of a commercial locator service, written documentation must be provided by the service establishing it as the agent of the person controlling the assets (e.g., a letter from the controller of the assets to the IRS, delegating authority to the entity, or a copy of the letter from the controller of the assets to the commercial locator service engaging its services). However, no documentation is necessary if the letter to be forwarded contains instructions to the intended recipient to contact the controller of the assets directly.

Upon receipt of a valid request, the IRS Disclosure Office will search its records under the Social Security number provided and, if an address is found, forward the letter using an IRS envelope. If an address cannot be found or the letter is returned by the postal service as undeliverable, the letter will be destroyed. The requester will not be notified of this action.

Sample Cover Letter to the IRS

Internal Revenue Service
Office of Disclosure
[Address]

To Whom It May Concern:

We hereby request the use of the Internal Revenue Service Letter Forwarding Service. We currently represent the [name of plan or organization], which plan is in the process of being terminated. We are seeking to contact the [number less than 50] individuals listed below, who are entitled to receive a

distribution of benefits from the terminated plan, but for whom we do not have addresses.

Enclosed is a list of the names, Social Security numbers, and last known addresses of the individuals we are seeking to contact. Also enclosed is a letter from us, directed to each of the missing individuals, advising each of a right to receive a distribution of plan benefits.

Thanking you in advance for your assistance in this matter

Sincerely,

[Appropriate officer or administrator]

Attachments:

1. List of missing former employees
2. Letters directed to each of the missing former employees

Sample Letter Directed to Missing Participants

[Letterhead with contact information]

[Participant's last known address]

Dear *[Participant]*:

According to our records, you have a vested benefit in the *[name of plan]*. This plan is currently in the process of being terminated and will shortly go out of existence. You are entitled to receive a distribution of your accrued benefits in the plan or, if you prefer, you may transfer your assets into another retirement plan of your choice. Once the plan goes out of business, it may become more difficult for you to locate and collect the money to which you are entitled.

In accordance with current policy, the IRS has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding the letter to you. Your response to this letter is completely voluntary.

Please contact us at the address or phone numbers listed above, so we can make arrangements to pay you the money you are owed.

We are looking forward to hearing from you in the near future.

Sincerely,

[Appropriate officer]

Forwarding Letters to 50 or More Individuals

This component of the Letter Forwarding Program, known as the Project 753 Computerized Mail-Out Program, is designed to contact large (i.e., more than 50) numbers of missing taxpayers.⁵ The following instructions apply to an individual or organization requesting that the IRS forward letters on its behalf to 50 or more individuals.

If the IRS determines that a submission is appropriate for the Letter Forwarding Program, the requester will be contacted with further instructions for forwarding letters to specific individuals. Thus, letters to be forwarded to specific individuals are not to be included in the initial submission.

The requestor should provide the following information:⁶

- A brief explanation of the need for letter forwarding
- The number of potential recipients
- Whether the requester has the Social Security number of each individual it wishes to contact on magnetic media specified by the IRS
- A sample of the letter to be forwarded (no more than three pages, front and back, may be used) on the individual's or organization's letterhead and signed by an authorized person
- An estimate of the value of assets being held by the requester for individuals who cannot currently be contacted
- A statement that the requester is aware that IRS will charge a fee for this service

The sample letter should be general in nature and contain the following statement in its opening paragraph, explaining IRS involvement in the Letter Forwarding Program. Do not include Social Security numbers or participant names on the outgoing sample letter:

In accordance with current policy, the Internal Revenue Service (IRS) has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding the letter. Your response to this letter is completely voluntary.

Generally, it will take 90 days from the IRS's acknowledgment of the request before the mailing can be performed. The charge for Project 753 requests is subject to change but currently is approximately \$1,750 plus \$.50 per record. A more precise cost estimate will be given upon request. Actual costs will be billed after completion of the mailing. The IRS will require that the requestor be able to provide the appropriate Social Security numbers on IBM

⁵ Rev. Proc. 94-22, 1994-1 CB 608.

⁶ The request should be forwarded to Internal Revenue Service Director, Office of Governmental Liaison and Disclosure, CL:GLD, Room 1603, Attn.: Irving Porter, 1111 Constitution, Avenue N.W., Washington, D. C. 20224.

3490-compatible cartridges, 3.5 inch computer disks, or such other magnetic media as it deems appropriate for the project.

A third-party individual or organization requesting the use of the IRS Letter Forwarding Program on behalf of another party that is actually holding assets for a missing taxpayer must provide additional information. (See the preceding discussion.)

Social Security Administration Letter Forwarding Program

The SSA also has a Letter Forwarding Program for advising participants of benefits. The SSA, like the IRS, will not confirm whether the participant has actually received the letter. The lost or missing participant's Social Security number is not required under the SSA Letter Forwarding Program.

The SSA program generally accepts up to 200 letters for forwarding at a charge of \$3 per participant. The letter should contain pertinent information, such as full name, date of birth, and Social Security number, which can be used to locate the individual. Generally, the plan administrator will receive a response within six to eight weeks if the search has been successful.

Plan administrators that want to use the SSA Letter Forwarding Program must follow all of the following procedures:

- Write a cover letter to the SSA explaining the need for letter forwarding (e.g., the need to locate a missing participant who is entitled to receive a benefit under a terminating plan).
- Write letters to the missing participants and enclose them in unsealed, unstamped envelopes with the plan administrator's return address.
- Provide as much information as the plan administrator knows about each missing participant, such as name, date of birth, last known address, and Social Security number if any.
- Include a check, payable to the SSA, for the applicable handling fee (\$3 times the number of letters to be forwarded).

Alternatively, if the quantity of letters to be forwarded is large, the plan administrator can seek the assistance of its local SSA office to send its letter-forwarding request to the Office Of Central Office Operations (OCRO).⁷

⁷ For more information, see <http://www.ssa.gov/foia/ltrfwding.htm>

Pension Benefit Guaranty Corporation Missing Participant Programs

The PBGC provides two methods by which a missing participant or beneficiary can be located, which are:

- *PBGC Pension Search Directory.* In an effort to locate missing participants, the PBGC created a *Pension Search Directory*. The directory, which will be updated quarterly, includes the names of people being sought, the names and headquarters locations of the companies where these people earned their pensions, and the date, if any, that the plans terminated. The directory can be found at <http://www.search.pbgc.com>.
- *PBGC Missing Participant Program.* The Employee Retirement Income Security Act of 1974, as amended (ERISA) provides rules for payments of benefits in a standard plan termination to participants whom the plan administrator cannot locate after a diligent search. The regulations establish procedures for the Missing Participants Program that apply to terminating single-employer defined-benefit plans.⁸ The regulations state that if a plan administrator does not purchase an annuity for a missing participant, the administrator pays the designated benefit to the PBGC after conducting a diligent search to locate the participant. To qualify as a diligent search, the plan administrator must:
 - Begin the search no more than six months before notices of intent to terminate are issued.
 - Carry on the search in such a manner that if the participant is found, distribution can reasonably be expected to be made on or before the deemed distribution date.
 - Ask any known beneficiaries of the missing participant (including alternate payees) for the missing participant's address.
 - Use a commercial locator service.

Other suggested search methods include mailing a letter to the missing participant's last-known address with a request to the post office for an address correction and use of the IRS Letter Forwarding Program. The plan administrator may use additional search methods. However, participants cannot be charged, nor can their benefits be reduced, to cover any search costs.⁹ The cost of using a private locator service or any other investigative service is considered an operating expense of the plan.

⁸ ERISA Section 4050.

⁹ PBGC Reg. Section 4050.4(b)(3).

The selection of an insurance company to provide an annuity must satisfy the same standards used for other participants, as follows:¹⁰

- The plan administrator must select the insurer in accordance with the fiduciary standards of Title I of ERISA.
- In the case of a plan in which any residual assets will be distributed to participants, a participating annuity contract may be purchased to satisfy the requirement that annuities be provided by the purchase of irrevocable commitments only if the portion of the price of the contract that is attributable to the participation feature:
 - Is not taken into account in determining the amount of residual assets.
 - Is not paid from residual assets allocable to participants.

Note. Because most insurance carriers will decline to issue an annuity contract without the participant's signature, purchasing an annuity contract may not be a feasible solution. Thus, paying the designated benefit to the PBGC, after a diligent search, may be the only solution.

Private Locator Services

A private (or commercial) locator service is another resource available to plan administrators that need to find missing participants in order to pay them their plan benefits. These services are called private locator services or commercial locator services to distinguish them from the locator services and letter forwarding programs.

Private locator services compile their computer databases from many sources, including state and other government records, such as birth certificates, death certificates, marriage licenses, motor vehicle department registrations, property records, divorce records, voter registration lists, court records, telephone company listings, credit checks, liens, and state limited partnership and corporation filings. The cost of using a private locator service may can be outweighed by the advantages of the results it may produce.

Internet Resources

Internet resources are available to plan administrators trying to locate missing participants. Use of Internet resources, however, will not satisfy the PBGC's requirement that the plan administrator use a private locator service,

¹⁰ See, generally, PBGC Reg. Sections 4041.28(c)(3), 4041.28(c)(4), 4050.3.

although it may be helpful. A listing of some of the available Internet sites follows:¹¹

- *INFO Space* at <http://www.infospace.com>. Once registered, the user can locate missing persons in the United States, Canada, and other countries.
- *Informus Corporation* at <http://www.informus.com/ssnlkup.html>. For a minimal fee, individuals can search Social Security numbers to determine whether a given number is valid. The year and state in which the SSN was issued is provided.
- *Database American Companies-Peoplefinder* at <http://www.database.america.com/html/gpfind.htm>. Residential directory assistance databases are used to search for individuals. Searches are by name or by telephone number, not by address.
- *Ancestry.com* at <http://www.ancestry.com/ssdi/advanced.htm>. The user can link directly to the Social Security Death Index on the Ancestry.com site to locate an individual's death information. Searches can be performed by name, address, Social Security number, birth date, and/or death date.
- *Switchboard* at <http://www.switchboard.com>. Switchboard is a directory that consists of residential and business databases. Searches are by name, city, and state.
- *555-1212.com* at <http://www.555-1212>. This site contains a directory of U.S. telephone numbers covers multiple databases.
- *AnyWho Directory Service* at <http://www.anywho.com>. The user can search for individuals by name, address, state, and telephone number.
- *InfoUSA* at <http://www.abii.com>. InfoUSA uses the American Directory Assistance database to locate individuals by their name, city, and state.
- *Four 11* at <http://www.Four11.com>. Yahoo-sponsored site can be used to locate an e-mail address or telephone number.

¹¹ This list was accurate (although by no means exhaustive), at the time of publication. Internet sites are constantly changing and new ones appear every day. For a current listing of locator services, go to Google (www.Google.com) or your favorite search engine and type in "locate missing persons" for additional, current services. Note, however, that not all the sites found will be reputable firms. Due diligence—and common sense—must be employed in determining the validity of a particular service provider.

Chapter 25

Nonqualified Deferred Compensation

By BRUCE J. McNEIL, Esq.

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Nonqualified Deferred Compensation

By BRUCE J. McNEIL, ESQ.

The primary issues that should be addressed with respect to nonqualified deferred compensation plans are:

1. *Nonqualified deferred compensation is merely an avoidance of current income taxation, and*
2. *Control over deferred compensation by an employee for whom the compensation has been deferred (by the employer)—with respect to investment allocation and the distribution of the deferred compensation—creates undesirable dominion and control over deferred compensation.*

This chapter provides a review of the applicable tax principles to address those issues and discusses the design and structure of nonqualified deferred compensation arrangements, in general.

Fundamental Doctrines and Theories of Tax

In general, for tax purposes, an unfunded nonqualified deferred compensation plan is one in which a participant in the plan has only the unfunded and unsecured promise of the employer that amounts will be paid when due under the terms of the plan. The employer may maintain separate bookkeeping accounts to reflect the deferred amounts, establish separate bank accounts, purchase assets such as securities or insurance contracts, and even place those assets in grantor trusts, commonly referred to as rabbi trusts, to assist the employer in meeting its liabilities under the plan. The plan is, nevertheless, unfunded so long as those accounts, assets, or trusts are not beyond the reach of the creditors of the employer. On the other hand, funded nonqualified deferred compensation plans are plans in which assets are placed beyond the reach of the creditors of the employer for the exclusive benefit of plan participants. In general, if the obligation of the employer and the rights of an em-

employee are secured in a manner that assures the employee of payment even in the face of the bankruptcy or insolvency of the employer, the plan is a funded plan.

The tax treatment of a nonqualified deferred compensation plan, in large part, is based on many of the fundamental doctrines and theories of income tax that have existed almost from the infancy of the federal tax system, rather than on specific statutory provisions. These theories and doctrines govern the timing of the recognition of income for the employee of the amounts payable under the deferred compensation plan, and determine the timing for the employee's employer to receive a deduction for the amounts that are payable under the deferred compensation plan.

Prior to 1942, accrual basis employers were generally allowed a current deduction for nonforfeitable liabilities to pay deferred compensation even though the compensation was paid and includable in the income of the employee in a later year.¹ This mismatching of the employer's deduction and the inclusion in income was eliminated by the Revenue Act of 1942, which added Section 23(p)(1)(D) to the Internal Revenue Code (IRC or the Code) of 1939, the predecessor to Section 404(a)(5) of the IRC of 1986. That provision tied the deduction to the time of payment, but no deduction was allowable for a transfer when taxation was postponed because the transferee's rights were forfeitable. (See Section 1.404(a)-12(c) of the Treasury Regulations.) The Tax Reform Act of 1969 corrected the language in the statute.

IRC Section 404(a) provides that compensation paid under a plan deferring the receipt of that compensation is not deductible under any other section of the Code. However, if it is otherwise deductible under IRC Section 162 (relating to trade or business expenses) or IRC Section 212 (relating to expenses for the production of income) and satisfies the conditions specified in IRC Section 404, it is deductible under IRC Section 404(a). In other words, the compensation must be tested under the reasonable compensation rules of IRC Section 162. With respect to unfunded and funded nonqualified deferred compensation plans, IRC Section 404(a)(5) allows the employer a deduction for compensation paid or contributions made in the taxable year in which "an amount attributable to the contribution is includable in the gross income of employees participating in the plan," provided that "separate accounts are maintained for each employee."

Reasonable Compensation

A nonqualified deferred compensation plan does not satisfy the requirements contained in IRC Section 401(a) and, as a result, does not receive the favorable tax treatment afforded the plans that do satisfy those requirements. Generally, contributions to an unfunded nonqualified deferred compensation plan are not deductible by an employer and are not includable in an employee's income until some future date when the benefits are distributed or made available to the employee. On the other hand, contributions to a funded plan are

¹ *Globe-Gazette Printing Co. v. Commissioner*, 16 B.T.A. 161 (1929), acq. IX-1 C.B. 20 (1930).

generally deductible by the employer and includable in an employee's income in the year the contribution is made.²

In *Wellons v. Commissioner*,³ the court disallowed the taxpayer's deductions for the funding of severance obligations on the basis that the payments made by the taxpayer were to a deferred compensation plan and, therefore, were not deductible. Finding that the plan benefits, which were based on salary and length of service, reflected the characteristics of a deferred compensation plan, the court held that the deduction for contributions to the plan's trust was governed by IRC Section 404(a)(5). Consequently, the contributions were deductible only when benefits were taxable to plan participants on distribution from the trust under IRC Section 404(a)(5).

IRC Section 404(a)(5) provides that an employer can deduct the amounts contributed to a nonqualified deferred compensation plan in the taxable year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee. IRC Section 404(d) contains a similar rule for the deduction of payments to a plan for independent contractors.⁴ Generally, a deduction is allowed only to the extent of the amount contributed and not the entire amount that is includable in the recipient's income.⁵

Section 1.404(a)-12(b)(1) of the Treasury Regulations provides that a deduction is allowable for a contribution under IRC Section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includable in his or her gross income as compensation, and then only to the extent allowable under IRC Section 404(a). For example, if an employer contributes \$1,000 to the account of an employee for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includable in the employee's gross income until the employee's taxable (calendar) year 1980 (at which time the includable amount is \$1,150), the employer's deduction for that contribution is \$1,000 in 1980 (if allowable under IRC Section 404(a)).

In Private Letter Ruling 9212024, dated December 20, 1991, which involved a trust created by an employer to fund benefits under a nonqualified plan, the Internal Revenue Service (IRS) discussed the rules under Section 1.404(a)-12(b)(1) of the Regulations in its analysis of the deduction timing rules. The IRS determined that the employer was entitled to deduct contributions made to the trust that were allocated to the trust accounts of participants in the taxable year in which amounts attributable to those contributions

² IRC Sections 83, 402(b), 404(a)(5), 404(d) and 451; Rev. Rul. 60-31, 1960-1 C.B. 174, 1960 WL 12882, as modified by Rev. Rul. 64-279, 1964-2 C.B. 121, 1964 WL 12635 and Rev. Rul. 70-435, 1970-2 C.B. 100, 1970 WL 20479; Private Ltr. Rul. 9206009, dated November 11, 1991, 9207010, dated November 12, 1991, 9212019, dated December 20, 1991, 9212024, dated December 20, 1991, and 9302017, dated October 15, 1992.

³ *Wellons v. Commissioner*, 31 F.3d 569 (7th Cir.1994).

⁴ Treas. Reg. Section 1.404(a)-12(b).

⁵ IRC Section 404(a)(5); Treas. Reg. Section 1.404(a)-12(b); Private Ltr. Rul. 9025018, dated March 22, 1990.

were includable in the gross income of the participants or beneficiaries to the extent such contributions were ordinary and necessary expenses within the meaning of IRC Section 162.

In Private Letter Ruling 9316018, dated January 22, 1993, which involved a secular trust established by an employee, the IRS determined that payments by the employer under the terms of the trust established by the employee were deductible by the employer in the year paid, to the extent the payments were ordinary and necessary expenses within the meaning of IRC Section 162.⁶

Because a vesting or secular trust is considered to be funded for tax purposes, the employer is entitled to deduct contributions to the trust in the year in which the contributions are made or, if later, the year in which participating employees become vested and, therefore, subject to tax on amounts attributable to those contributions to the extent such contributions are considered ordinary and necessary expenses paid or incurred in carrying on a trade or business. Because the employer cannot be the owner of a vesting or secular trust and the income is taxable to the trust, the employer may not deduct trust income.⁷ Thus, the amount of the deduction is equal to the amount of the contribution, which, because of trust earnings, could be less than the entire amount includable in the employee's gross income in accordance with Section 1.404(a)-12(b)(1) of the Treasury Regulations.

Section 1.404(a)-12(b)(2) of the Treasury Regulations provides that if unfunded pensions are paid directly to former employees, such payments are includable in their gross income when paid, and, accordingly, such amounts are deductible under IRC Section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing the employee's salary for a reasonable period), and if such amounts meet the requirements of IRC Section 162 or 212, such amounts are deductible under IRC Section 404(a)(5) in any case when they are not includable under the other paragraphs of IRC Section 404(a).

In Private Letter Ruling 9350018, dated September 17, 1993, which involved a nonqualified plan and a rabbi trust, the IRS stated that IRC Section 404(a)(5) provides the general deduction timing rules applicable to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to IRC Section 404(a)(5) and Section 1.404(a)-12(b)(2) of the Treasury Regulations, and provided that they otherwise meet the requirements for deductibility amounts of contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which they are paid or made available, whichever is earlier. In another ruling involving a rabbi trust, Private Letter Ruling 9504006, dated October 19, 1994, the employer was entitled to a deduction pursuant to IRC Section 404(a)(5) for amounts paid or made available under the plan and out of the trust only in the taxable year in

⁶ Private Ltr. Ruling 9417013, dated April 29, 1994, regarding the tax consequences with respect to a vesting trust.

⁷ Propose Treas. Reg. Section 1.671-1(g)(1).

which the amounts were includable in the gross income of the participant or his beneficiary, provided such amounts otherwise met the requirements for deductibility under IRC Section 162.

Because the rabbi trust is treated as unfunded for tax purposes, the employer is not entitled to deduct the contributions to the trust in the year in which they are made. The employer is generally entitled to a deduction under IRC Section 404(a)(5) in the year the participating employee is subject to tax. The amount of the deduction is the amount contributed to the trust, plus earnings, that is distributed to the employee. Under IRC Section 671, the employer must include all of the income, deductions, and credits of the trust in computing its own taxable income and credits. Thus, the earnings, which are considered an asset of the employer, are treated as contributed or paid by the employer when they are distributed to the employee.

A significant element of IRC Section 404(a)(5) is that, in order to be deductible under IRC Section 404(a)(5) and the regulations thereunder, amounts contributed to a nonqualified plan must also be ordinary and necessary business expenses under IRC Section 162. IRC Section 162(a)(1) allows a deduction with respect to “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Section 1.162-9 of the Income Tax Regulations provides that bonuses paid to employees are deductible “when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered.” Whether an expense that is claimed pursuant to IRC Section 162(a)(1) is reasonable compensation for services rendered is a question of fact that must be decided on the basis of the facts and circumstances. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, pursuant to Section 1.404(a)-1(b) of the Treasury Regulations and Private Letter Ruling 9347012, dated August 18, 1993, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year.

The language in IRC Section 404(a)(5) of the Code provides that contributions under a deferred compensation plan are deductible in the taxable year in which an amount attributable to the contribution is includable in the gross income of an employee participating in the plan. The deduction is matched with the inclusion of income. As Daniel Halperin noted, “in the case of deferred payment of compensation under nonqualified plans, Congress has imposed ‘a matching requirement,’ which denies an employer’s deduction until the de-

ferred amount is included in the employee's income."⁸ To allow an employer "to deduct [deferred amounts] prior to their receipt by their employees would contravene the clear purpose of the taxation scheme governing deferred compensation agreements."⁹ This tax tension between the deferral desired by an employee and the current deduction desired by the employer is an inherent limitation on the amount of deferred compensation that a taxable employer would be willing to provide to the employee.

And, the timing rules governing the recognition of income by an employee are found in the doctrines and theories of constructive receipt, economic benefit, assignment of income, cash equivalency, the transfer of property, and dominion and control. These doctrines and theories impose a standard and structure to deferred compensation plans implemented by employers and promote fair and equitable tax policy.

Constructive Receipt

Generally, contributions pursuant to a nonqualified deferred compensation plan are not includable in a participating employee's income under the constructive receipt doctrine; if the employee's control over the contributions is subject to substantial limitations, then contributions to a nonqualified deferred compensation plan should not be subject to the constructive receipt doctrine. Under IRC Section 451(a) and Section 1.451-1(a) of the Treasury Regulations, a taxpayer includes the amount of any item of gross income in his or her gross income for the taxable year in which he or she receives it, unless, under the taxpayer's method of accounting, it is properly included in a different period.¹⁰

IRC Section 451(a) provides that a taxpayer reporting on the cash method of accounting must include an item in income for the taxable year in which such item is actually or constructively received. Section 1.451-2(a) of the Treasury Regulations defines the term *constructive receipt* as "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

Thus, under the constructive receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment. The doctrine precludes the taxpayer from deliberately turning his back upon income otherwise available.¹¹

⁸ Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 *Yale L.J.* 506, 520 (1986) (discussing IRC Section 404).

⁹ *Albertson's Inc. v. Commissioner*, 42 F.3d 537, 546 (9th Cir. 1994), aff'g 95 T.C. 415 (1990).

¹⁰ See Private Ltr. Rul. 9505012, dated November 4, 1994.

¹¹ *George C. Martin v. Commissioner*, 96 T.C. 814, 1991 WL 104315 (1991).

The background for understanding the concept of the constructive receipt doctrine and its application to nonqualified deferred compensation plans is found in several early revenue rulings that applied to certain deferred compensation plans. Revenue Ruling 60-31¹² sets forth the rules of constructive receipt in the area of deferred compensation agreements. This leading ruling in the field of deferred compensation agreements has been sustained by the courts.¹³ Revenue Ruling 60-31¹⁴ notes with appropriate authority that “[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method,” and proceeds to review when and under what circumstances certain contractual benefits may be treated as constructively received.

In Revenue Ruling 71-332,¹⁵ a profit-sharing plan provided that a participant could withdraw any part of his vested account balance, prior to termination of employment, in the case of financial need but only to the extent approved by the plan’s administrative committee. Any participant who desired to make such a withdrawal was required to make a written application to the committee. The committee had the sole discretion to determine whether financial necessity existed and, if so, what portion of the participant’s vested account balance could be withdrawn. The plan also provided that, in approving withdrawals, the committee was required to follow a uniform and nondiscriminatory policy.

An employee whose vested account balance was \$3,000 made application for a withdrawal of \$500 because of a financial need. The committee subsequently approved the application for withdrawal both as to need and as to amount. However, the employee later found that he could relieve his financial need by withdrawing only \$400 and only that amount was actually withdrawn.

The IRS found that although the employee could have applied for a withdrawal of the entire vested account balance of \$3,000, he was not considered to be in constructive receipt of that amount since the requirement in the plan for substantiating financial need, obtaining approval of the administrative committee, and the acceptance of whatever terms and conditions such committee could impose, constituted substantial restrictions or conditions on the employee’s right of withdrawal. However, the \$500 amount approved for withdrawal by the committee was actually the maximum amount permitted as a withdrawal in this case and, therefore, was made available to the employee. Accordingly, the employee was required to include \$500 in gross income for the year the committee’s approval was granted for the withdrawal of such amount rather than the \$400 actually withdrawn.

¹² Rev. Rul. 60-31, 1960-1 C.B. 174.

¹³ See *Goldsmith v. United States*, 586 F.2d 810, 815-18, 218 Ct.Cl. 387 (1978).

¹⁴ Rev. Rul. 60-31, 1960-1 C.B. 174.

¹⁵ Rev. Rul. 71-332, 1971-2 C.B. 210.

In Revenue Ruling 77-34,¹⁶ a profit-sharing plan provided that an employee could withdraw his or her entire interest in the funds contributed to the plan at any time. However, if such a withdrawal was made, the employee incurred a 12-month suspension from participating under the plan, at the expiration of which, the employee could reenter the plan. During the period of suspension, no contributions could be made by the company on behalf of the employee. An employee who had been a participant in the plan for 20 years died while still employed, having made no request for a withdrawal. The entire amount credited to the decedent's account was payable to the designated beneficiary in several payments over a period of years. The question was whether the decedent's beneficiary received the decedent's share of the plan under the terms of the plan, or from the decedent who constructively received the payments prior to death. The IRS stated that if participants were permitted to withdraw employer contributions subject to the suspension of participation for a specified period during which no contributions were made by the employer on behalf of such employees, such suspension represented a substantial restriction or limitation and the amounts that were permitted to be withdrawn were not made available to the employee. Therefore, the decedent's interest in the employee trust was not constructively received prior to death.¹⁷

The payment of a financial percentage, or what is commonly referred to as a *haircut* is related to the concept of plan suspension established to limit withdrawals and has been considered to be a limitation or restriction on the availability of compensation. In Revenue Ruling 55-423,¹⁸ which involved a plan suspension, the IRS noted that

[i]n the penalty type of case a participant, who makes a withdrawal, is required to discontinue his participation in the trust or suffer a forfeiture with respect to a portion of his distributable interest. Discontinuance of participation is the surrender of a valuable right and, as long as that remains a condition for withdrawal of his interest, such interest is not made available to the participant.

Although the IRS indicated its approval of the haircut concept, the IRS did not specifically state the amount of a haircut that would be necessary to preclude constructive receipt. In determining the amount that may be considered to be a substantial limitation or restriction on the availability of deferred compensation, 10 percent is regarded as a substantial penalty amount, primarily based upon the early withdrawal penalty applicable to distributions from qualified plans, individual retirement accounts or annuities (IRAs), and IRC Section 403(b) annuities prior to attaining age 59½ as described in IRC Section 72(t). Under IRC Section 72(t), such withdrawals are generally subject to a 10-percent excise tax unless they are rolled over or they meet specific standards for an exception described in that section. Support for the use of the

¹⁶ Rev. Rul. 77-34, 1977-1 C.B. 276.

¹⁷ Rev. Rul. 77-34, 1977-1 C.B. 276, was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, to the extent it referred to IRC Sections 2039(c), (d), (e), (f), or (g).

¹⁸ Rev. Rul. 55-423, 1955-1 C.B. 41.

10-percent amount as a sufficient penalty for premature withdrawals is based in part on the legislative history of IRC Section 72(t), which indicates that Congress believed 10 percent would be a “substantial deterrent to prevent an owner-employee from treating his retirement plan as a tax-free savings account [from] which he can withdraw prior to retirement.”¹⁹ The IRS has also used the term *substantial deterrent* in General Counsel Memoranda to be synonymous with “substantial limitations or restrictions” when describing means to avoid the application of constructive receipt.²⁰

In Revenue Ruling 77-139,²¹ the participant, at the time of death, was the president and sole shareholder of a corporation and participated in the corporation’s noncontributory pension plan and, pursuant to the provisions of the plan, the decedent’s spouse was designated beneficiary of a life annuity. The question was whether the decedent’s sole ownership of the corporation gave the decedent the unrestricted right to receive the decedent’s interest in a qualified pension plan necessary for application of the constructive receipt doctrine, or whether the decedent’s beneficiary received such interest under the terms of the plan. The IRS stated that if a qualified plan of a corporation with one shareholder was terminated before the retirement or death of the participant shareholder, the corporation was required to establish that abandonment of the plan was attributable to reasons which justified not having the plan’s qualification revoked retroactively. The IRS determined that the power of the decedent to terminate the plan was sufficiently restricted to prevent invocation of the doctrine of constructive receipt.²²

In Revenue Ruling 80-158,²³ the decedent was a participant in the employer’s noncontributory profit-sharing plan that provided for the purchase of ordinary paid-up life insurance policies on the lives of all participating employees. On the decedent’s retirement date, two policies that had been purchased by the trustee of the plan on the decedent’s life were surrendered for two supplemental policies. Under the terms of the supplemental contracts, the decedent as primary payee was to receive monthly annuity payments for life with 10 years of payments guaranteed in any event. In addition, although the supplemental policies were not distributed to the decedent, the decedent had the right to designate a contingent beneficiary as the payee of any proceeds payable at death and had the right to surrender the supplemental contracts and receive the commuted value of the guaranteed payments. Upon the decedent’s death, the remaining guaranteed installments under the supplemental contracts were paid to the designated contingent beneficiary. In this case, the decedent had the right during the 10-year period of guaranteed payments to surrender the rights under the profit-sharing plan for the commuted value of the remaining guaranteed payments. If the decedent had exercised the right

¹⁹ H.R. Rep. No. 779, 93d Cong., 2d Sess. p. 116, 1974-3 C.B. 359.

²⁰ See, e.g., GCM 37562.

²¹ Rev. Rul. 77-139, 1977-1 C.B. 278.

²² Rev. Rul. 77-139, 1977-1 C.B. 278, 1977 WL 44402 was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, 1988 WL 546812, to the extent it referred to Sections 2039(c), (d), (e), (f), or (g).

²³ Rev. Rul. 80-158, 1980-1 C.B. 196.

to receive the commuted value of the guaranteed payments, the decedent would have suffered a significant economic penalty, because the amount required to purchase a new annuity of comparable value would have been greater than the commuted value of the remainder of the 10-year certain payments. Thus, the decedent's control over the guaranteed payments was subject to a substantial limitation or restriction, and the decedent's interest in the profit-sharing trust was not constructively received by the decedent prior to death.²⁴

In Revenue Ruling 80-300,²⁵ a corporation adopted a plan under which key employees of the corporation were granted stock appreciation rights. The stock appreciation rights entitled the employee to a cash payment equal to the excess of the fair market value (FMV) of one share of the common stock of the corporation on the date of the exercise of the stock appreciation right over the FMV of a share on the date the stock appreciation right was granted to the employee. The IRS stated that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital was a valuable right. However, once the employee exercised the stock appreciation rights, the employee lost all chance of further appreciation with respect to that stock and the amount payable became fixed and available without limitation. Accordingly, the employee would be in receipt of income on the day the stock appreciation rights were exercised.

Generally, as long as the deferred compensation arrangement is unfunded or contains a substantial restriction, such as a period of nonparticipation or an economic penalty, and the participants in the arrangement have no current right to receive a payment under the arrangement, the doctrine of constructive receipt will not apply. Also, pursuant to several court opinions which have addressed this doctrine, if an agreement to defer compensation is entered into prior to the period of service for which the compensation is payable or to the date on which the amount payable is ascertainable, the doctrine is not likely to be applied.

Economic Benefit Doctrine

Contributions made pursuant to a nonqualified deferred compensation plan are generally not includable in the employee's income under the economic benefit doctrine, which identifies when income has actually been received other than by a direct payment of cash. If contributions are made or amounts set aside in accordance with a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions or amounts should not be subject to the economic benefit doctrine. However, if contributions to the plan are protected from the employer's creditors and the rights of the plan participants to the benefits provided under the plan

²⁴ Rev. Rul. 80-158, 1980-1 C.B. 196, was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, to the extent it referred to IRC Sections 2039(c), (d), (e), (f), or (g).

²⁵ Rev. Rul. 80-300, 1980-2 C.B. 165.

are nonforfeitable, the economic benefit doctrine should apply, and the contributions would be includable in the participant's income.

Under the economic benefit doctrine, if any economic or financial benefit is conferred on an individual as compensation in a taxable year, it is taxable to the individual in that year. In *Commissioner v. Smith*,²⁶ an employer gave an employee, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later years, when the market value of the stock was greater than the option price, the employee exercised the option, purchasing large amounts of the stock in each year. The Tax Court had determined that the excess of the market value of the shares over the option price in the years in which the shares were received by the employee was compensation for his services and taxable as income in those years. The United States Supreme Court agreed and concluded that the employee received an economic benefit at the time he received the shares and, as a result, the employee had taxable income in each year in which stock was acquired.

Assignment of Income Doctrine

The doctrine of assignment of income is similar to the economic benefit doctrine because, as the United States Supreme Court pointed out in *Helvering v. Horst*,²⁷ the power to dispose of income represents the equivalent of ownership and the exercise of a power to dispose of income represents the equivalent of taxable enjoyment. If a future benefit may be currently assigned to another party, the person assigning the benefit may be subject to current taxation under this doctrine.²⁸

The doctrine was formalized by the United States Supreme Court in *Lucas v. Earl*.²⁹ The question in that case was whether Earl could be taxed for the whole of the salary and attorneys' fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife. The contract, made in 1901, provided that the salary and fees earned by Earl became the joint property of Earl and his wife on the very first instant on which they were received. The Court held that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." The Court further stated that it believed that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

²⁶ *Commissioner v. Smith*, 324 U.S. 177, 65 S.Ct. 591, 89 L.Ed. 830 (1945), reh. den. 324 U.S. 695, 65 S.Ct. 891, 89 L.Ed. 1295 (1945).

²⁷ *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940).

²⁸ *United States v. Basye*, 410 U.S. 441, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973), rehearing denied 411 U.S. 940, 93 S.Ct. 1888, 36 L.Ed.2d 402 (1973).

²⁹ *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930).

In *Commissioner v. P.G. Lake, Inc.*,³⁰ the taxpayers assigned the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as, and when produced in return for cash. The Court concluded that, while the oil payments were interests in land, the consideration received for the oil payment rights was taxable as ordinary income because the lump-sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income.

Thus, the assignment of income doctrine is likely to be applied if a taxpayer assigns his or her right to receive a benefit to a third party as consideration for some other benefit. However, the assignment of income doctrine is not likely to be applied in the case if a benefit promised under the terms of a deferred compensation plan may not be alienated, sold, transferred, or assigned.³¹

Cash Equivalency Doctrine

The cash equivalency doctrine is similar to the economic benefit doctrine and the assignment of income doctrine, and provides that if a promise to pay some benefit to an individual is unconditional and can be exchanged for cash, then the promise is equivalent to cash and subject to current taxation.

If a promised benefit may not be transferred or assigned to another party and is subject to certain conditions, this doctrine should not apply.

Transfer of Property

The creation of a nonqualified deferred compensation plan generally will not result in a transfer of property to an employee triggering tax under IRC Section 83. If contributions or amounts set aside in accordance with a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, such contributions or amounts should not be considered to be a transfer of property under IRC Section 83. In general, IRC Section 83 provides rules for the taxation of property transferred to any person in connection with the performance of services. This property is generally not taxable to the person until it has been transferred to such person or becomes substantially vested in such person. Section 1.83-3(a)(1) of the Treasury Regulations provides that a transfer of property occurs when a person acquires a beneficial ownership interest in the property.³²

Section 1.83-3(b) of the Treasury Regulations provides that property is substantially vested for purposes of IRC Section 83 when it is either transferable or not subject to a substantial risk of forfeiture. Section 1.83-3(c) of the Treasury Regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfei-

³⁰ *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), rehearing denied 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071 (1958).

³¹ Private Ltr. Rul. 9340032, dated July 6, 1993, regarding the division of nonqualified deferred compensation in a divorce, and Private Ltr. Rul. 9405021, dated November 8, 1993, for recent discussions of the assignment of income doctrine.

³² See TAM 9438001, dated April 21, 1994, for a discussion regarding the application of IRC Section 83 on a stock option arrangement.

ture exists if rights in property that are transferred are conditioned upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Section 1.83-3(d) of the Treasury Regulations provides that the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Treasury Regulations provides that for purposes of IRC Section 83, the term *property* includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor.

If employer contributions made pursuant to a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions are not considered property under IRC Section 83. Therefore, at the time the contributions are made, there is no transfer of property under IRC Section 83. However, if the contributions are not available to the employer and are protected from the employer's general creditors in the event of the employer's bankruptcy, and the participating employee is fully vested in the contributions, then a transfer of property would be considered to have occurred under IRC Section 83 and the employee would be subject to tax on the transferred amount.

Dominion and Control

A question frequently raised is whether a right of a participant in a nonqualified deferred compensation plan to select among various investment options offered under the terms of the plan should trigger current income. Control over the investment of deferred amounts raises the issue of whether the participant is entitled to the deferred compensation if the participant exercises control over the deferred compensation. Simply stated, the issue is whether some degree of dominion or control over the deferred compensation should lead to earlier taxation.

The regulations under IRC Section 457, however, provide a basis for arguing that the ability to direct investments should not result in current taxation to the participant. The IRS has puzzled over participant involvement in the investment process and has issued a number of opinions and rulings that considered participant involvement in the investment process. In early opinions and rulings, the IRS determined that involvement in the investment process by a participant could cause the benefits to be currently taxable. However, subsequent opinions and rulings have indicated that such involvement is acceptable so long as the trustee of a trust or the employer sponsoring the plan is not obligated to obtain the assets requested as an investment.

In the early years, the IRS concluded that amounts withheld from an employee's gross income under a nonqualified deferred compensation plan were currently includable in the employee's gross income if the employee had a right to receive income but voluntarily directed the employer to withhold it and the employee could direct the employer to invest the sums for the employee's benefit. In General Counsel Memorandum (GCM) 36998 (February 9, 1977), the IRS reviewed two proposed revenue rulings regarding the investment of assets under deferred compensation agreements. In the GCM, the IRS stated that it believed that the amounts withheld from the compensation of participating employees in the plans subject to the proposed revenue rulings were includable in the gross income of the employees in the year withheld because the employees had exercised sufficient "dominion and control" over the withheld amounts to warrant the imposition of income tax upon them.

The dominion and control theory has not, however, been advanced in subsequent opinions and rulings regarding the investment of assets in connection with a nonqualified deferred compensation plan. The subsequent opinions and rulings have relied on the analysis of the constructive receipt doctrine and the economic benefit doctrine.

The rulings issued by the IRS subsequent to the publication of GCM 36998 in 1977, pertaining to the investment of assets to be used, directly or indirectly, for the payment of deferred compensation or retirement benefits of highly compensated employees (HCEs) have varied. In a number of cases, the employer set aside funds and the employee was permitted, by the plan or trust, to suggest the manner of investing the assets, but the employer or trustee was not required to follow the advice. In other rulings, funds were invested by a fiduciary in the type of assets requested or selected by the participant (usually from a specified group of assets). In each of the rulings, the IRS concluded that the ability under the applicable trust of the participant to recommend investments in a certain asset, or to benefit from the indexed earnings of a particular investment even though that investment was not required to be made with specified assets, did not generally result in the funds in the trust or allocated under the plan being treated as currently taxable to the employee.

The purpose of deferred compensation generally is to provide benefits to a select group of HCEs to permit the employees' employer to attract such employees and to provide "a means to retain valuable employees."³³ Furthermore, "Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I

³³ *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283 (2d Cir. 2000).

[of ERISA].”³⁴ To cast a wider net and include a significant number of employees in a nonqualified deferred compensation plan could impose a significant tax burden on the employer, which would require the current recognition of the liability but a deferral of the deduction for the deferred amounts.

Deferred Compensation

Nonqualified deferred compensation arrangements are an important method for compensating executives and HCEs of both publicly held and private companies, as well as key personnel of tax-exempt organizations. Because of the flexibility of these plans, for taxable employers at least, and the wide variety of plan designs, the reasons for these arrangements are as varied as the plans themselves. Although many of the purposes of the plans may be driven by nontax considerations, the tax and accounting consequences are always important elements.

The objective of an employee in participating in these plans is typically to ensure that he or she will be taxed only when payments are actually received under the agreement; to permit deferred amounts to grow on a pretax and tax-deferred basis during the deferral period; and to have amounts paid concurrently with some specific purpose, such as retirement. The motive of the employer providing these arrangements is most often the need to attract and retain the people who are essential to the growth and future of the company. After all, most of the competitors of the employer provide similar benefits to their executives or prospective executives. Having agreed to provide deferred compensation, an employer also wants to ensure that it receives a deduction for the deferred amounts when the compensation is paid or payable to the employee.

Retirement income is probably the primary reason for nonqualified deferred compensation arrangements. Before the Employee Retirement Income Security Act of 1974, as amended (ERISA), there were no dollar limits on contributions and benefits under qualified plans, and executives generally accrued retirement benefits under those plans just like other salaried employees. With ERISA, however, monetary limitations on qualified plans first appeared. Since then, tax legislation has added further complexity, restrictions, and limitations to qualified plans. Although in the past, the qualified plan may have provided the bulk of the retirement income of an executive and a nonqualified plan played only a secondary role, the roles have now been reversed with the limitations on contributions and benefits under qualified plans. In many instances, the nonqualified deferred compensation plan has become the principle source of executive retirement benefits.

A nonqualified deferred compensation plan is narrow in focus and coverage, and not without risk to a participant. The typical form of a nonqualified deferred compensation plan is a plan commonly referred to as a top-hat plan.

³⁴ Department of Labor Advisory Opinion 90-14A, dated May 8, 1990.

Top-Hat Plan

The term *top-hat* refers to a plan described in IRC Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, as an employee benefit plan which is unfunded and maintained by an employer “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.” A top-hat plan is exempt from the substantive provisions of ERISA, Parts 2, 3, and 4 of Title I of ERISA, pertaining to participation, vesting, funding, and fiduciary responsibilities pursuant to the exemptions in Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA.³⁵ A top-hat plan is a common form of a deferred compensation arrangement that is designed to avoid the application of both the constructive receipt doctrine and the economic benefit doctrine.

Whether a plan falls within this description is not easily determined but there is some guidance regarding the interpretation of the terms used in this phrase that is helpful in making such a determination.

Primarily

The Department of Labor (DOL) stated in a footnote in DOL Advisory Opinion 90-14A, dated May 8, 1990, that it is the position of the department that

[T]he term “primarily,” as used in the phrase “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees” in sections 201(2), 301(a)(3) and 401(a)(1), refers to the purpose of the plan (i.e., providing benefits) and not the participant composition of the plan. Therefore, a plan which extends coverage beyond “a select group of management or highly compensated employees” would not constitute a “top hat” plan for purposes of Parts 2, 3 and 4 of Title I of ERISA.

In other words, according to the DOL, *primarily* applies only to “the purpose of providing deferred compensation” and does *not* apply to “a select group of management or highly compensated employees.” This effectively means that the plan can cover *only* “a select group of management or highly compensated employees.”

Select Group

The term *select group* has been the subject of interpretation by several courts. The court in *Belka v. Rowe Furniture Corporation*,³⁶ found that a plan covering only 4.6 percent of the employer’s total number of employees was within the meaning of a select group. In *Darden v. Nationwide Mutual Insurance Company*,³⁷ the district court found that a group comprising almost one-fifth

³⁵ *Carr v. First Nationwide Bank*, 816 F.Supp. 1476 (N.D.Cal.1993).

³⁶ *Belka v. Rowe Furniture Corporation*, 571 F. Supp. 1249 (D. Md. 1983).

³⁷ *Darden v. Nationwide Mutual Insurance Company*, 717 F. Supp. 388, 396-97 (E.D.N.C. 1989), *aff’d*, 922 F. 2d 203, 208 n.3 (4th Cir. 1991), *rev’d* 503 U.S. 318, 112 S. Ct. 1344, 117 L. Ed. 2d 581 (1992), on remand 969 F. 2d 76 (4th Cir. 1992).

of the employer's total work force was too large to be considered select for purposes of the top-hat exemption. (On appeal, Nationwide did not contest this conclusion.) In *Starr v. JCI Data Processing, Inc.*,³⁸ the court found that where participation in a plan was predicated on whether an employee had previously worked for the employer's former parent company, resulting in participation representing many levels from nonsupervisory clerical positions (38 percent), line supervisors (25 percent), and upper management (38 percent), whose salaries ranged from \$12,000 to \$336,000, the plan was not for the benefit of a select group of management or highly compensated employees. In *Carrabba v. Randalls Food Markets, Inc.*,³⁹ the district court stated that "[t]he definition of a top hat plan has been described as a narrow one. See *In re New Valley Corp.*, 89 F. 3d 143, 148 (3d Cir. 1996), *cert. denied*, 519 U.S. 1110, 117 S. Ct. 947, 136 L. Ed. 2d 835 (1997)." The District Court articulated its view regarding the definition of a top-hat plan:

[a] legitimate top hat plan must cover a "select group" of employees who are "only high-level employees." [Citing *In re New Valley Corp.*] The mere fact that the employer intends the plan to be a reward to "key" employees does not satisfy the degree of selectivity contemplated by the statutes. See *Hollingshead v. Burford Equip. Co.*, 747 F. Supp. 1421, 1429 (M. D. Ala. 1990). Rather, the statute contemplates that a top hat plan will be for the benefit of "high-ranking employees."⁴⁰

Management

The term *management* has been the subject of interpretation in the legislative history of ERISA. As an example of an unfunded plan primarily devoted to providing deferred compensation for a select group of management or HCEs, the legislative history of ERISA cites a "phantom stock" or "shadow stock" plan established solely for the officers of a corporation. For an employer with many officers, this would suggest a broad interpretation of who may be considered eligible to participate in a top-hat plan. However, the DOL has ruled that a plan which covered all of the employees on an employer's executive payroll was not a plan maintained for a select group of management or HCEs in view of the broad range of salaries and positions held by the employees. Apparently, the DOL has taken a narrow approach with respect to the definition of this term for purposes of the top-hat plan exemption.⁴¹

Highly Compensated

The DOL has also taken a narrow approach with respect to the interpretation of the term *highly compensated*. Specifically, the department's position is that the term is narrower than the definition of *highly compensated employee* un-

³⁸ *Starr v. JCI Data Processing, Inc.*, 757 F. Supp. 390, 393-94 (D. N. J. 1991), opinion vacated in part on reconsideration 767 F. Supp. 633 (D. N. J. 1991).

³⁹ *Carrabba v. Randalls Food Markets, Inc.*, 38 F. Supp. 2d 468, 477 (N.D. Tex. 1999).

⁴⁰ *Carrabba* at 477.

⁴¹ H. R. Conf. Rep. No. 93-1280, 93rd Cong., 2d. Sess. 296 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 5038, 5076-77; Department of Labor Advisory Opinion 85-37A, October 25, 1985.

der the IRC. In the preamble to Section 1.414(q)-1T of the Treasury Regulations, which provides rules for determining which employees are HCEs for purposes of IRC Section 414(q), published on February 19, 1988,⁴² the Department of Treasury stated that the DOL has jurisdiction over the interpretation of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA. However, the Department of Treasury further stated that it “would like to clarify its understanding that section 414(q) is not determinative with respect to provisions of Title I of ERISA, other than those provisions that explicitly incorporate such section by reference (e.g., section 408(b)(1)(B) of ERISA).” Furthermore, the Department of Treasury stated in the preamble that “[t]he Departments of Treasury and Labor concur in the view that a broad extension of section 414(q) to determinations under sections 201(2), 301(a)(3), and 401(a)(1) of ERISA would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank-and-file employees.”⁴³

Ambiguity in Plan Terms

Although the status of a plan as a top-hat plan may turn on the interpretation of the terms used to define a top-hat plan, the compensation payable under the plan may turn on the precise use of the terms in the plan.

Reason for ERISA Exemption for Top-Hat Plans

The participants in a top-hat plan are considered to be knowledgeable about the employer and the risks and rewards related to such a plan, not requiring the protection of ERISA; therefore, they can influence the design and benefits of a top-hat plan and assume the associated risks.

The DOL expressed its view of the reason for, and justification of, the top-hat exemption in DOL Advisory Opinion 90-14A, dated May 8, 1990:

[i]t is the view of the Department that in providing relief for “top-hat” plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].

Because of this legislative purpose, the phrase “select group of management or highly compensated employees” will be interpreted narrowly by the DOL.⁴⁴

⁴² 53 Fed. Reg. 4965, 4967 (February 19, 1988).

⁴³ 53 Fed. Reg. 4965, 4967 (February 19, 1988).

⁴⁴ See also DOL Adv. Op. 92-13A, dated May 19, 1992.

Whether a Plan Satisfies the Purpose and the Description of a Top-Hat Plan

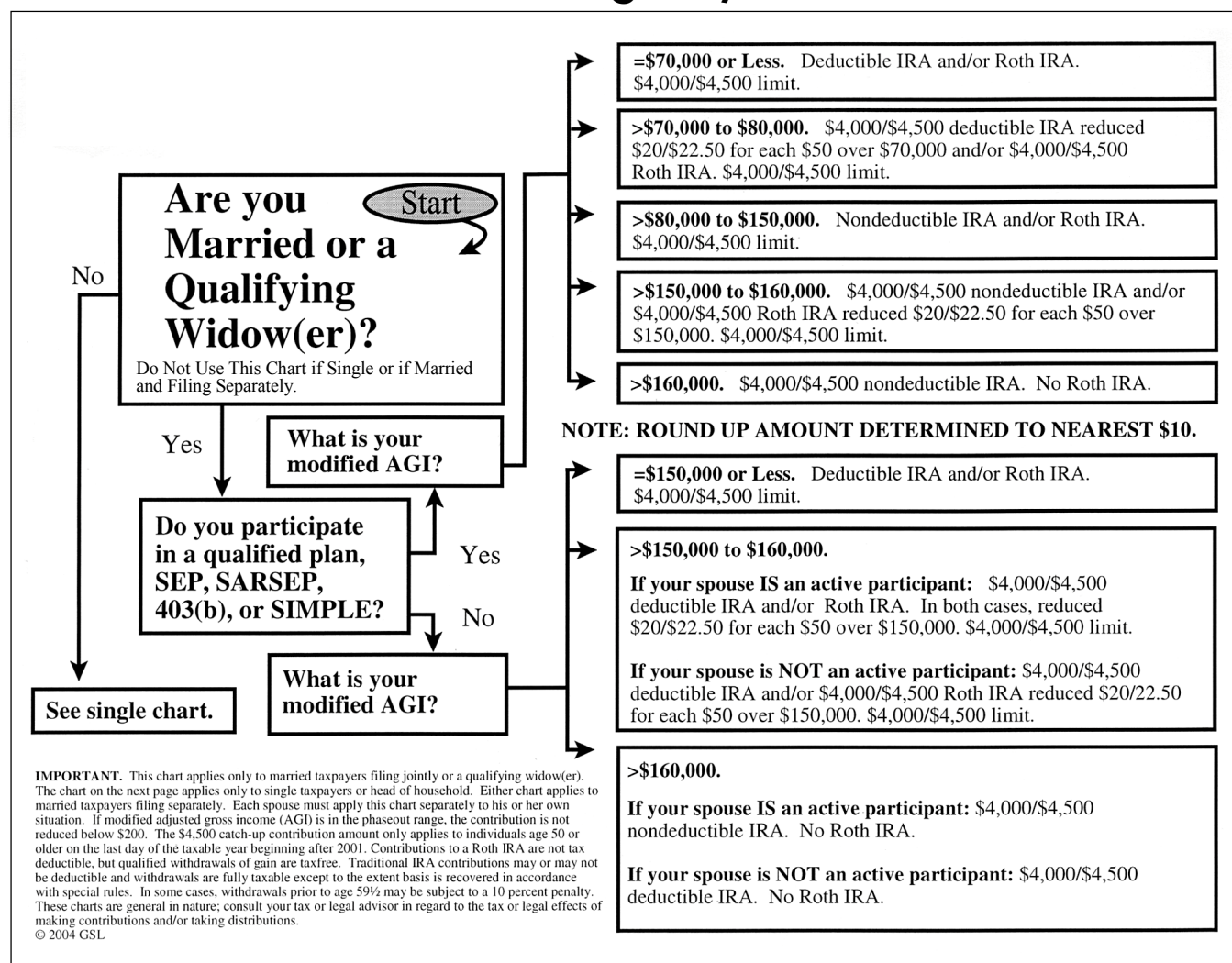
The courts have generally taken the position that ERISA should be liberally construed in favor of employee benefit fund participants and that exemptions from the ERISA coverage should be confined to their narrow purpose.

Although the DOL has not issued any rulings specifically stating how a top-hat plan is defined for purposes of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, the guidance issued by the Departments of Labor and Treasury, and the courts suggests that the eligibility requirements for participation in a nonqualified deferred compensation plan that is intended to satisfy the definition of a top-hat plan should be narrowly applied so that the number of employees who are eligible to participate is limited to a select group of high-level employees whose average compensation is significantly greater than the average compensation of all other employees.

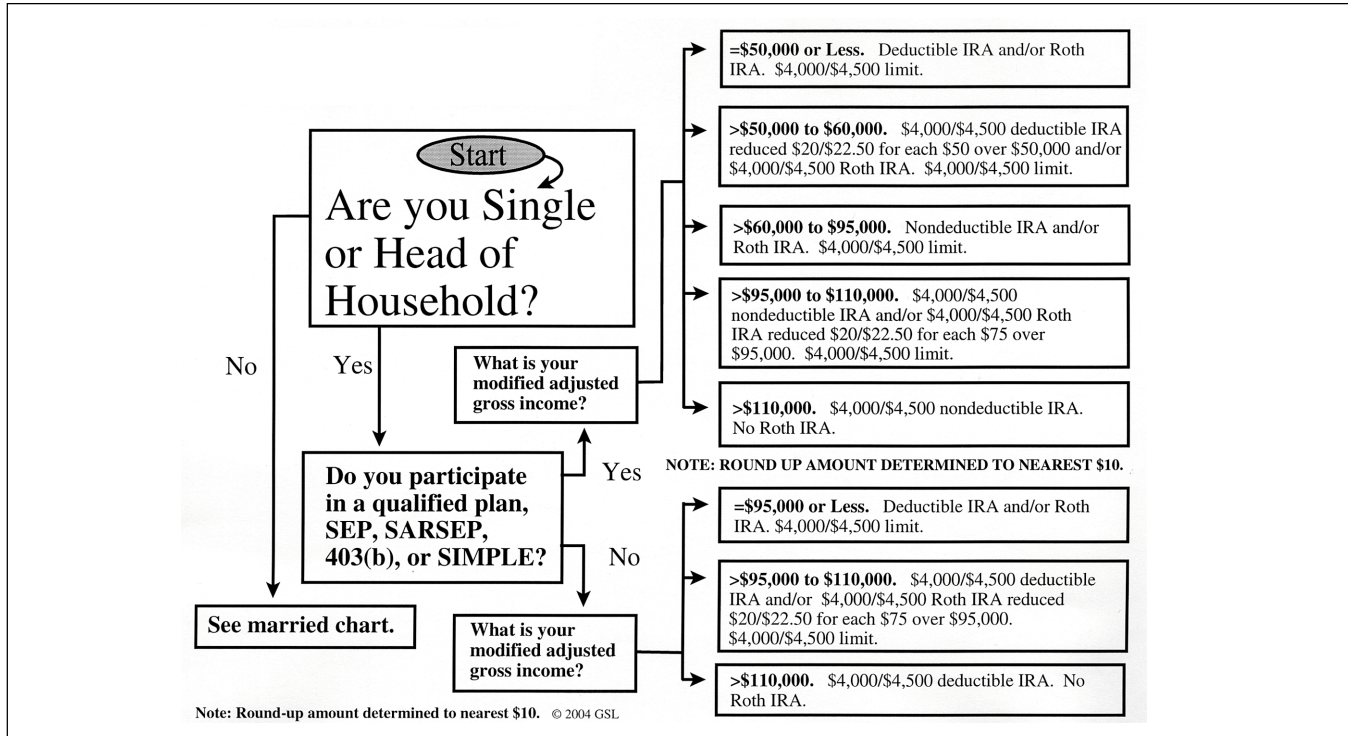
Appendix A

Plan Feature Comparison Charts

Traditional IRA and Roth IRA Eligibility for 2005



Traditional IRA and Roth IRA Eligibility for 2005



Tax-Sanctioned and Tax-Qualified Plan Comparison Chart

	Payroll Deduction IRA	SEP	SIMPLE IRA Plan	Defined Contribution Plans			Defined Benefit
				401(k)	Profit-Sharing	Money Purchase	
Key Advantage	Easy to set up and maintain.	Easy to set up and maintain.	Salary reduction plan with little administrative paperwork.	Permits higher level of salary deferrals by employees than other retirement vehicles.	Permits employer to make large contributions for employees.	Permits employer to make large contributions for employees.	Provides a fixed, pre-established benefit for employees.
Employer Eligibility	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with 100 or fewer employees that does not currently maintain another retirement plan.	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with one or more employees.
Employer's Role	Arrange for employees to make payroll deduction contributions. Transmit contributions for employees to IRA. No annual filing requirement for employer.	Set up plan by completing IRS Form 5305-SEP. No annual filing requirement for employer.	Set up plan by completing IRS Form 5304-SIMPLE or IRS Form 5305-SIMPLE. No annual filing requirement for employer. Bank or financial institution processes most of the paperwork.	No model form to establish this plan. Advice from a financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required. Also may require annual non-discrimination testing to ensure plan does not discriminate in favor of highly compensated employees.	No model form to establish this plan. Advice from a financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required.	No model form to establish this plan. Advice from a financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required.	No model form to establish this plan. Advice from a financial institution or employee benefit advisor would be necessary. Annual filing of Form 5500 is required. An actuary must determine annual contributions.
Contributors To The Plan	Employee contributions remitted through payroll deduction.	Employer contributions only.	Employee salary reduction contributions and employer contributions.	Employee salary reduction contributions and/or employer contributions.	Annual employer contribution is discretionary.	Employer contributions are fixed.	Primarily funded by employer.
Maximum Annual Contribution (Per participant)	\$3,000 for 2002 – 2004; \$4,000 for 2005 – 2007; \$5,000 for 2008. Additional contributions can be made by participants age 50 or over.	Up to 25% of compensation ¹ or a maximum of \$41,000.	Employee: Up to \$7,000 (for 2002) with \$1,000 annual incremental increases until the limit reaches \$10,000 in 2005. Additional contributions can be made by participants age 50 or over. Employer: Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 out of 5 yrs.); or contribute 2% of each eligible employee's compensation ² .	Employee: \$11,000 in 2002 with \$1,000 annual incremental increases until the limit reaches \$15,000 in 2006. Additional contributions can be made by participants age 50 or over. Employer/Employee Combined: Contributions per participant up to the lesser of 100% of compensation ¹ or \$41,000. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.	Contributions per participant up to the lesser of 100% of compensation ¹ or \$41,000. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.	Contributions per participant up to the lesser of 100% of compensation ¹ or \$41,000. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.	Actuarially determined contribution.
Contributor's Options	Employee can decide how much to contribute at any time.	Employer can decide whether to make contributions year-to-year.	Employer can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation. ¹	Employee can elect how much to contribute pursuant to a salary reduction agreement. The employer can make additional contributions, including possible matching contributions, as set by plan terms.	Employer makes contribution as set by plan terms. Employee contributions, if allowed, as set by plan terms.	Employer makes contribution as set by plan terms. Employee contributions, if allowed, as set by plan terms.	Employer generally required to make contribution as set by plan terms.
Minimum Employee Coverage Requirements	Should be made available to all employees.	Must be offered to all employees who are at least 21 years of age, employed by the employer for 3 of the last 5 years and had earned income of \$450 (for 2004 and 2005).	Must be offered to all employees who have earned income of at least \$5,000 in any prior 2 years, and are reasonably expected to earn at least \$5,000 in the current year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, Loans and Payments	Withdrawals permitted anytime subject to Federal income taxes; early withdrawals subject to tax penalty.	Withdrawals permitted anytime subject to Federal income taxes; early withdrawals subject to tax penalty.	Withdrawals permitted anytime subject to Federal income taxes; early withdrawals subject to tax penalty.	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.). Plan may permit loans; early withdrawals subject to tax penalty.	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.). Plan may permit loans; early withdrawals subject to tax penalty.	Payment of benefits after a specified event occurs (e.g., retirement, plan termination, etc.). Plan may permit loans; early withdrawals subject to tax penalty.	Payment of benefits after a specified event occurs (e.g., retirement, plan termination, etc.). Plan may permit loans; early withdrawals subject to tax penalty.
Vesting	Contributions are immediately 100% vested.	Contributions are immediately 100% vested.	Employer and employee contributions are immediately vested 100%.	Employee salary deferrals are immediately 100% vested. Employer contributions may vest over time according to plan terms.	Employer contributions may vest over time according to plan terms. Employee contributions, if any, are immediately 100% vested.	Employer contributions may vest over time according to plan terms. Employee contributions, if any, are immediately 100% vested.	Right to benefits may vest over time according to plan terms.

¹ Maximum compensation on which 2005 contribution can be based is \$205,000. Based on 2005 estimated limits (\$205,000, \$41,000, \$450). See Appendix C.
² Maximum compensation on which 2004 and 2005 employer 2% non-elective contributions can be based is \$205,000.
 Note: Catch-up elective contributions may be made in addition to the amount determined under the \$41,000/100% limit (see IRC 414(v)(3)).
 Source: www.irs.gov, modified by author May 2004.

Comparison of SEP, SARSEP, and SIMPLE IRA Plans

	SEP	SARSEP	SIMPLE IRA Plan
General Comments	Employer sets up IRAs for eligible employees and makes contributions to the IRAs. Amount of the contributions can be discretionary.	SEPs that also allow employees to make salary reduction contributions. SARSEPs are no longer available to employers who did not already have one as of 12/31/96.	Generally replaces SARSEPs. Allows for salary reduction contributions. Requires employer to commit to specified rates of matching or nonelective contributions.
Applicable Code Sections	<p>408(k) Generally, IRAs (set up by or for eligible employees) that satisfy the requirements of: 408(k)(2), (3), (4) and (5); and if the plan is top-heavy, the requirements of 416(c)(2). See 408(k)(1).</p> <p>408(k)(2)- Participation 408(k)(3)- Nondiscrimination 408(k)(4)- Withdrawals 408(k)(5)- Written allocation formula</p>	<p>SEP requirements plus 408(k)(6). A SEP may include a salary reduction arrangement under which the employee may elect to have the employer either make elective contributions under the SEP on behalf of the employee or make payments to the employee directly in cash. The salary reduction arrangement must satisfy the provisions of 408(k)(6). Other provisions of 408(k) apply to all SEPs, including SARSEPs.</p>	<p>408(p) Generally, IRAs referred to as "simple retirement accounts" that satisfy the requirements of: 408(p)(3), (4) and (5); and only allow contributions pursuant to a "qualified salary reduction arrangement." See 408(p)(1). "Qualified salary reduction arrangement" - The arrangement includes deferrals and the employer contributions required under the arrangement. See 408(p)(2).</p> <p>408(p)(3)- Vesting 408(p)(4)- Participation 408(p)(5)- Administrative requirements</p>

	SEP	SARSEP	SIMPLE IRA Plan
Eligible Employer	No restriction	<p>Salary reduction arrangements cannot be part of a SEP after 12/31/96. Exception: Salary reduction arrangements already in existence as of 12/31/96 can continue. See 408(k)(6)(H).</p> <p>Salary reduction arrangements not available for a SEP if there are more than 25 eligible employees in the previous year. See 408(k)(6)(B).</p> <p>State/local governments and tax-exempt organizations cannot sponsor a SARSEP. See 408(k)(6)(E).</p>	<p>An employer with no more than 100 employees who received at least \$5,000 of compensation from the employer during the preceding year.</p> <p>2-year grace period - An employer that previously maintained a SIMPLE IRA plan is treated as satisfying the 100-employee limitation for two calendar years following the calendar year in which it last satisfied the 100-employee limitation. See 408(p)(2)(C)(i). Employer cannot sponsor another qualified plan. See 408(p)(2)(D).</p> <p>"Excludable employees" included in 100 employee limitation. Employees include all employees employed at any time during the calendar year. See Notice 98-4, B-1.</p>

	SEP	SARSEP	SIMPLE IRA Plan
Participation	<p>Cannot be less generous than:</p> <p><u>Age</u> - 21</p> <p><u>Service</u> - Performed service for the employer during any 3 of the preceding 5 years.</p> <p><u>Compensation</u> - At least \$300 in compensation (subject to COLA adjustment) for the year (2003, 2004, 2005* = \$450). See 408(k)(2).</p> <p>May exclude - collectively bargained (CBA) employees whose retirement benefits have been subject to good faith bargaining; nonresident aliens with no US income (408(k)(2); 410(b)(3)(A)/(C) cross reference in 408(k)(2)).</p>	Same rule as SEPs.	<p>Cannot be less generous than:</p> <p><u>Age</u> - n/a</p> <p><u>Service</u> - n/a</p> <p><u>Compensation</u> - an employee who (1) received at least \$5,000 in compensation from the employer during any 2 preceding years; and (2) is expected to receive at least \$5,000 in compensation in the current year. Can exclude- CBA employees, nonresident aliens as provided for in 410(b)(3). See 408(p)(4).</p>
Vesting	<p>Full and immediate - (408(a)(4)/408(b)(4))</p> <p>All contributions are made to IRAs. IRAs are either: Individual Retirement Accounts - defined in 408(a) or Individual Retirement Annuities - defined in 408(b). 408(a)(4) requires an employee to be fully vested in his/her Individual Retirement Account. 408(b)(4) requires an employee to be fully vested in his/her Individual Retirement Annuity.</p>	Same rule as SEPs	Full and immediate - (408(p)(3))

	SEP	SARSEP	SIMPLE IRA Plan
Coverage	<p>No "coverage" type test. If an employee satisfies the eligibility provisions of the SEP, the employee participates. No eligibility requirements in addition to the conditions provided for in 408(k)(2) (regarding participation) can be imposed. "Employee" includes all employees by application of the controlled group/affiliated service group/leased employee rules. See 414(b), (c), (m)(4)(B), (n)(3)(B). Note - no "1,000 hours of service"; "last day of employment" requirements.</p>	Same rule as SEPs plus at least 50% of eligible employees must make deferrals for a year.	<p>No "coverage" type test. "Employee" includes all employees by application of the controlled group/affiliated service group/leased employee rules. See 414 (b), (c), (m)(4)(B), (n)(3)(B). Note - no "1,000 hours of service"; "last day of employment" requirements.</p>

	SEP	SARSEP	SIMPLE IRA Plan
Non-discrimination	<p>Cannot discriminate in favor of highly compensated employees (HCEs). General rule - contribution allocation formula is compensation to compensation. Variations - (1) permitted disparity under 401(l) is also allowed. See 408(k)(3). (2) allocation formulas where contribution rates decrease as compensation levels increase are allowed. See Proposed Regulation 1.408-8(c)(1).</p>	<p>Salary deferrals - must satisfy requirements of 408(k)(6)(A) i.e., (1) choice of salary reduction or direct cash payment must be provided to employees, (2) at least 50% of eligible employees must elect to have payments made to the SEP, and (3) the deferral percentage for any HCE cannot be more than 1.25 times average deferral percentage for non-HCEs. The employer must notify any HCE with "excess contributions" (on account of failing the "1.25 test") within 2.5 months of the close of the year to avoid the 4979 tax; and by the close of the following plan year to preserve tax deferred status of deferrals. See Regulation 54.4979-1(a)(4). Employee's deferral percentage = deferral to the SEP divided by compensation (not to exceed 401(a)(17) limit). See 408(k)(6)(D) and (k)(8). 401(a)(17) limit - 2001 = \$170,000, 2002 and 2003 = \$200,000; 2004 and 2005* = \$205,000. If other employer contributions - same rule as SEPs.</p>	<p>Only deferrals and employer matching or nonelective contributions are allowed. See 408(p)(1) and 408(p)(2).</p>

	SEP	SARSEP	SIMPLE IRA Plan
Contribution Limits	<p>Employer contributions - contributions on behalf of an employee cannot exceed the lesser of (1) 25% of compensation or (2) the 415(c) dollar limit (2002 and 2003 = \$40,000; 2004 and 2005* = \$205,000). See 402(h)(2).</p> <p>See 402(h)(2). Also note - dollar limit for HCE is reduced in an integrated plan by the amount of his/her allocation that is attributable to permitted disparity. See 402(h)(2)(B), 408(k)(3)(D), and 401(l)(2).</p>	<p>Elective deferrals - 402(g) limits apply. See 408(k)(6)(A). The 402(g) limits are in addition to the nondiscrimination limitations on HCEs, "1.25 test". See narrative for nondiscrimination and 408(k)(6)(A). Applicable 402(g) limits - 2003=\$12,000 2004=\$13,000 2005=\$14,000 414(v) catch-up contribution limits in addition to 402(g) limits for participants who, by the end of the year, are at least 50 years old: 2002 = \$1,000 2003 = \$2,000 2004 = \$3,000 2005 = \$4,000 2006 = \$5,000 If other employer contributions - same rule as SEPs.</p>	<p>Elective deferrals - Limited to dollar limit provided for in 408(p)(2)(E), i.e., 2001 = \$6,500, 2002 = \$7,000, 2003 = \$8,000, 2004 = \$9,000, and 2005* = \$10,000. Similar to SARSEPs, 414(v) catch-up contribution limits also apply for participants who, by the end of the year, are at least 50 years old; except the catch-up amounts are half of the SARSEP amounts. Employer contributions - either (1) matching contributions equal to 100% of deferrals up to a maximum of 3% of compensation, or (2) nonelective contributions equal to 2% of compensation (not to exceed \$205,00 for 2004 and \$2005) for all eligible employees. The matching contribution 3% limit can be reduced for a calendar year to a limit not below 1%, if the limit is not reduced for more than 2 years out of the 5 year period. The 5 year period includes the year of election. Also, the "3% limit" can only be reduced if employees are notified within a reasonable time before the "60-day" election period during which employees can make deferrals. See 408(p)(2)(A),(B),and (C)(ii).</p>

	SEP	SARSEP	SIMPLE IRA Plan
With- drawals	Withdrawals must be permitted. See 408(k)(4). Income tax and 72(t) apply.	Same rule as SEP, but adverse tax consequences if distribution before 1.25% test performed. See 408(d)(7)(A).	Withdrawals must be permitted. See Notice 98-4 F2. Income tax and 72(t) apply. Note: 72(t) tax is 25%, instead of 10% if withdrawals are made during the 2 year period beginning on the date the employee first participated in the SIMPLE IRA Plan. See 72(t)(6).
Written Allocation Formula	Written allocation formula should specify (1) the requirements that an employee must satisfy in order to receive an allocation, and (2) the manner in which the amount allocated is computed. See 408(k)(5).	Same rule as SEP – applies to other employer contributions, if any.	Plan formula may only consist of the permitted matching or nonelective contributions. See 408(p)(2).
415 Limits Apply?	Yes. See 415(a)(2)(C).	Yes. See 415(a)(2)(C).	No. See 415(a).
402(g) Limits Apply?	n/a	Yes. See 402(g)(3)(B).	Yes. See 402(g)(3)(D).
Top- Heavy Rules Apply ?	Yes. See 416(i)(6).	Yes. See 416(i)(6).	No. See 416(g)(4)(G).

	SEP	SARSEP	SIMPLE IRA Plan
Administrative Requirements Imposed By Statute	Yes, see 408(i) and 408(l) for reporting and disclosure requirements to individual participants and the Service. Detailed guidance on the reporting and disclosure requirements can be found in Regulation 1.408-6 and Proposed Regulation 1.408-5. The Department of Labor also has certain disclosure requirements for SEPs.	Yes, same as for SEPs.	Yes. See 408(p)(5). (1) Elective deferrals must be deposited no later than 30 days after the last day of the month with respect to which contributions are to be made. (2) Matching/nonelective contributions must be made no later than the due date for filing the employer's income tax returns, including extensions, for the taxable year that includes the last day of the calendar year for which contributions are made. (3) During the 60-day period before the beginning of any year (and the 60-day period before the first day that an employee is first allowed to participate) an employee must be afforded the opportunity to elect to participate in the salary reduction arrangement or to elect to modify the amounts contributed to such arrangement. (4) An employee may elect to terminate participation in such arrangement at any time during the year. The arrangement may provide that the employee may not elect to resume participation until the beginning of the following year. Also, see Notice 98-4 section G for employer administrative and notification requirements; and section H for trustee administrative requirements. The Department of Labor also has certain disclosure requirements for SIMPLE IRA plans.

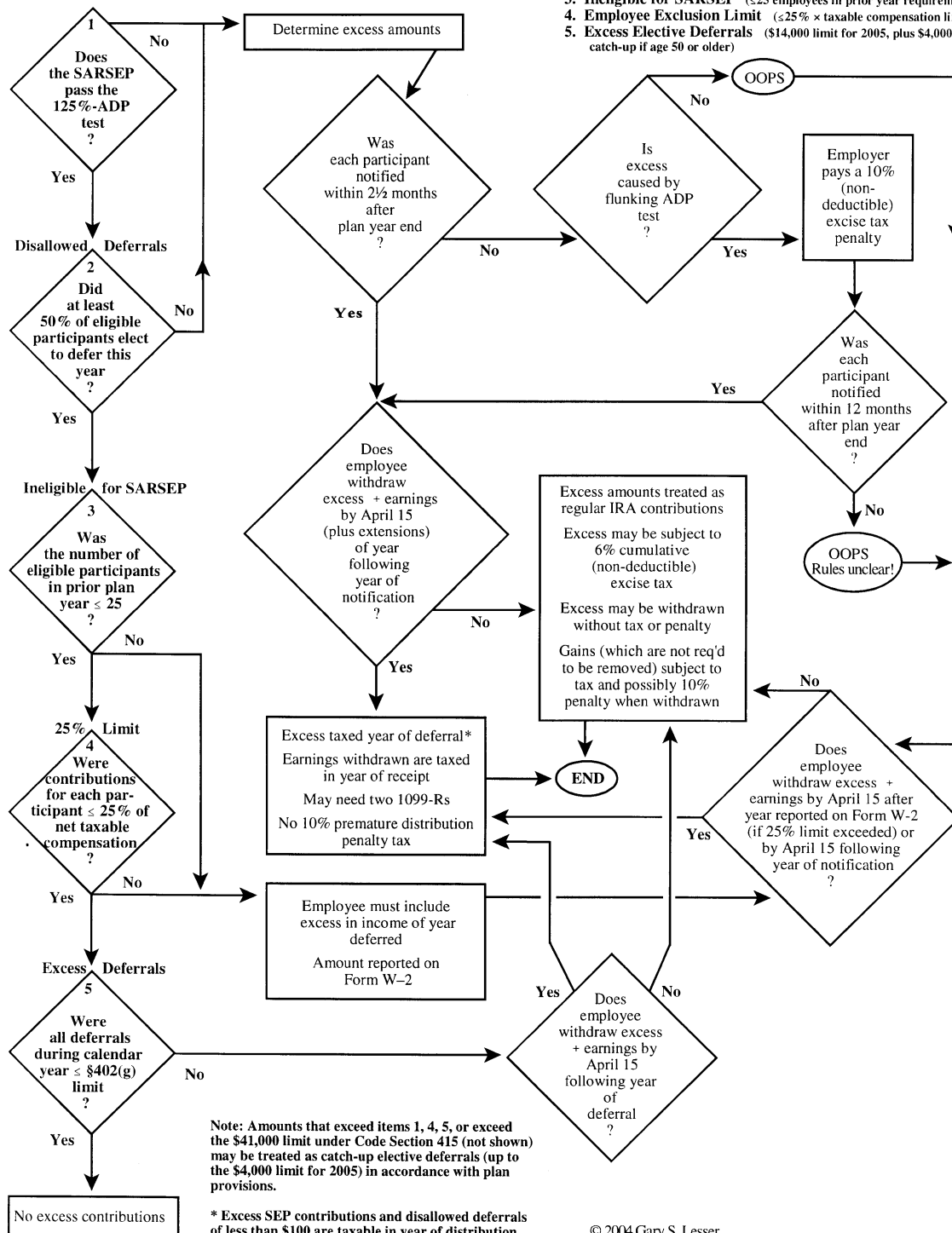
	SEP	SARSEP	SIMPLE IRA Plan
Plan Documents	IRS model - Form 5305-SEP. Restrictions - (1) cannot be used if employer maintains another plan, (2) can only provide compensation-to-compensation allocation formula. Other alternative - IRS approved prototype; typically sponsored by a financial institution.	IRS model - Form 5305A-SEP. If employer also wants to provide for employer contributions, employer can adopt Form 5305-SEP in conjunction with the Form 5305A-SEP. Other alternative - IRS approved prototype; typically sponsored by a financial institution. Note: SARSEP documents only apply to SARSEPs that were in existence as of 12/31/96.	IRS model forms - 2 options: (1) Form 5305-SIMPLE - designated financial institution (DFI) receives all employer contributions for deposit to SIMPLE-IRAs for employees. (2) Form 5304-SIMPLE - no DFI. Employee can choose the financial institution for SIMPLE-IRA contributions. Other alternative - IRS approved prototype; typically sponsored by a financial institution.

	SEP	SARSEP	SIMPLE IRA Plan
IRA Document	In addition to the plan document, each employee has to execute a traditional IRA document. The document sets up the SEP-IRA to accept contributions for the employee. The IRS has issued two model documents for traditional IRAs (that can be used as SEP-IRAs). The two model documents are Form 5305 for a trustee IRA and Form 5305-A for a custodial account. Other alternative - Prototype document; typically developed by a financial institution.	Same as SEP	In addition to the plan document, each employee has to execute a "SIMPLE IRA" document. The document sets up the SIMPLE IRA to accept contributions made under a SIMPLE IRA plan. IRS has issued two model documents for SIMPLE IRAs: Form 5305-S is for a trustee IRA and a Form 5305-SA is for a custodial account. Other alternatives- Prototype document; typically developed by a financial institution.
Voluntary Compliance Options Under Rev. Proc. 2003-44	VCP	VCP	VCP

* Amounts indicated for 2005 (\$41,000, \$450, \$205,000) are estimated; see Appendix C. Source: www.irs.gov, modified by author May 2004.

Excess SEP/SARSEP Contributions

Key: 1. Excess SEP Contributions (125% ADP test)
 2. Disallowed Deferrals (at least 50% test)
 3. Ineligible for SARSEP (≤ 25 employees in prior year requirement)
 4. Employee Exclusion Limit ($\leq 25\% \times$ taxable compensation limit)
 5. Excess Elective Deferrals (\$14,000 limit for 2005, plus \$4,000 catch-up if age 50 or older)



Appendix B

Plan Illustrations

SIMPLE IRA Plan for a Corporation

(SIMPLE IRA, see Chapter 3)				SIMPLE ILLUSTRATOR				n				16-Feb-2004			
SIMPLE IRA				#1 MATCHING CONTRIBUTION											
2004 <- Plan Year				C Entity Type (C, P, or S)				UP TO 3 %							
3.00% <- General Matching				C = Corporation								98.67% <- Owner % of Total E/er			
1.00% <- Alternate Matching				P = Partnership or LLC				SIMPLE IRA				94.13% <- Owner % of Matching			
I <- SIMPLE IRA				S = Sole-Proprietorship								\$177,741.50 <- Owner Total			
Y <- Catch-Up												\$81,400.00 <- Nonowner Total			
												\$259,141.50 <- Plan Total			

(SIMPLE IRA, see Chapter 3)						2004					
#2 _ _ _ _ _ A L T E R N A T I V E M A T C H I N G _ _ _ _ _						#3 _ _ _ _ _ N O N E L E C T I V E C O N T R I B U T I O N _ _ _ _ _					
U P T O : 1.00%						2.00% -- Statutory rate.					
S I M P L E I R A						S I M P L E I R A					
99.48% <- Owner % of Total E/er						99.02% <- Owner % of Total E/er					
94.13% <- Owner % of Matching						93.17% <- Owner % of Nonelective					
\$152,080.50 <- Owner Total						\$161,071.00 <- Owner Total					
Maximum \$79,800.00 <- Nonowner Total						\$80,600.00 <- Nonowner Total					
Match \$231,880.50 <- Plan Total						\$241,671.00 <- Plan Total					
1.00%						\$5,000.00 <- Min. Comp.					
Salary Reduction Amount	W-2 Compensation	Matching Amounts	Total SIMPLE Contribution	Taxable Income		Salary Reduction Contribution	W-2 Compensation	Non-Elective Contribution	Total SIMPLE Contribution	Taxable Income	
# \$218,250.00	\$1,363,050.00	\$13,630.50	\$231,880.50			# \$218,250.00	\$1,363,050.00	\$23,421.00	\$241,671.00		
1 \$10,500.00	\$300,000.00	\$3,000.00	\$13,500.00	\$289,500.00		1 \$10,500.00	\$300,000.00	\$4,100.00	\$14,600.00	\$289,500.00	
2 \$10,500.00	\$200,000.00	\$2,000.00	\$12,500.00	\$189,500.00		2 \$10,500.00	\$200,000.00	\$4,000.00	\$14,500.00	\$189,500.00	
3 \$10,500.00	\$100,000.00	\$1,000.00	\$11,500.00	\$89,500.00		3 \$10,500.00	\$100,000.00	\$2,000.00	\$12,500.00	\$89,500.00	
4 \$10,300.00	\$10,300.00	\$103.00	\$10,403.00			4 \$10,300.00	\$10,300.00	\$206.00	\$10,506.00		
5 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			5 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
6 \$7,725.00	\$7,725.00	\$77.25	\$7,802.25			6 \$7,725.00	\$7,725.00	\$154.50	\$7,879.50		
7 \$7,500.00	\$7,500.00	\$75.00	\$7,575.00			7 \$7,500.00	\$7,500.00	\$150.00	\$7,650.00		
8 \$5,000.00	\$5,000.00	\$50.00	\$5,050.00			8 \$5,000.00	\$5,000.00	\$100.00	\$5,100.00		
9 \$1,000.00	\$1,000.00	\$10.00	\$1,010.00			9 \$1,000.00	\$1,000.00		\$1,000.00		
10 \$9,000.00	\$300,000.00	\$3,000.00	\$12,000.00	\$291,000.00		10 \$9,000.00	\$300,000.00	\$4,100.00	\$13,100.00	\$291,000.00	
11 \$9,000.00	\$200,000.00	\$2,000.00	\$11,000.00	\$191,000.00		11 \$9,000.00	\$200,000.00	\$4,000.00	\$13,000.00	\$191,000.00	
12 \$9,000.00	\$100,000.00	\$1,000.00	\$10,000.00	\$91,000.00		12 \$9,000.00	\$100,000.00	\$2,000.00	\$11,000.00	\$91,000.00	
13 \$9,000.00	\$10,300.00	\$103.00	\$9,103.00	\$1,300.00		13 \$9,000.00	\$10,300.00	\$206.00	\$9,206.00	\$1,300.00	
14 \$9,000.00	\$10,000.00	\$100.00	\$9,100.00	\$1,000.00		14 \$9,000.00	\$10,000.00	\$200.00	\$9,200.00	\$1,000.00	
15 \$7,725.00	\$7,725.00	\$77.25	\$7,802.25			15 \$7,725.00	\$7,725.00	\$154.50	\$7,879.50		
16 \$7,500.00	\$7,500.00	\$75.00	\$7,575.00			16 \$7,500.00	\$7,500.00	\$150.00	\$7,650.00		
17 \$5,000.00	\$5,000.00	\$50.00	\$5,050.00			17 \$5,000.00	\$5,000.00	\$100.00	\$5,100.00		
18 \$1,000.00	\$1,000.00	\$10.00	\$1,010.00			18 \$1,000.00	\$1,000.00		\$1,000.00		
19 \$9,000.00	\$10,000.00	\$100.00	\$9,100.00	\$1,000.00		19 \$9,000.00	\$10,000.00	\$200.00	\$9,200.00	\$1,000.00	
20 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			20 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
21 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			21 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
22 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			22 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
23 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			23 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
24 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			24 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
25 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			25 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		
26 \$10,000.00	\$10,000.00	\$100.00	\$10,100.00			26 \$10,000.00	\$10,000.00	\$200.00	\$10,200.00		

401(k) SIMPLE Plan for a Corporation

(401(k) SIMPLE PLAN, see Chapter 3)				SIMPLE ILLUSTRATOR				401(k) SIMPLE				16-Feb-2004			
401(k) S I M P L E				#1 _ _ _ _ M A T C H I N G C O N T R I B U T I O N _ _ _ _ _				U P T O 3 %							
2004 <- Plan Year				C Entity Type (C, P, or S)				98.65% <- Owner % of Total E/er							
3.00% <- General Matching				C = Corporation				93.71% <- Owner % of Matching							
1.00% <- Alt. Matching - N/A				P = Partnership or LLC				\$160,999.75 <- Owner Total							
K <- 401(k) SIMPLE				S = Sole-Proprietorship				\$70,300.00 <- Nonowner Total							
Y <- Catch-Up								\$231,299.75 <- Plan Total							
				Take Home or Desired Salary Reduction Amount								Net IRC 415			
Eligible Employees				Year of Birth				Owner Enter "o"				Enter Pre-Plan W-2 Compensation			
Catch-Up Amt				\$1,500				Totals:				\$1,363,050.00			
1 1950 . o				\$300,000.00				0.999 <- %				1 \$10,500.00 \$300,000.00 \$6,150.00 \$16,650.00 \$289,500.00 \$205,000			
2 1950 . o				\$200,000.00				0.999 Max				2 \$10,500.00 \$200,000.00 \$6,000.00 \$16,500.00 \$189,500.00 \$201,500			
3 1950 . o				\$100,000.00				0.999 Max				3 \$10,500.00 \$100,000.00 \$3,000.00 \$13,500.00 \$89,500.00 \$101,500			
4 1950 . o				\$10,300.00				0.999 Max				4 \$10,300.00 \$10,300.00 \$309.00 \$10,609.00 \$11,600			
5 1960 o				\$10,000.00				0.999 Max				5 \$9,000.00 \$10,000.00 \$300.00 \$9,300.00 \$1,000.00 \$10,000			
6 1950 o				\$7,725.00				0.999 Max				6 \$7,493.25 \$7,725.00 \$231.75 \$7,725.00 \$231.75 \$7,725			
7 1950 . o				\$7,500.00				0.999 Max				7 \$7,275.00 \$7,500.00 \$225.00 \$7,500.00 \$225.00 \$7,500			
8 1950 . o				\$5,000.00				0.999 Max				8 \$4,850.00 \$5,000.00 \$150.00 \$5,000.00 \$150.00 \$5,000			
9 1950 . o				\$1,000.00				0.999 Max				9 \$970.00 \$1,000.00 \$30.00 \$1,000.00 \$30.00 \$1,000			
10 1960 o				\$300,000.00				0.999 Max				10 \$9,000.00 \$300,000.00 \$6,150.00 \$15,150.00 \$291,000.00 \$205,000			
11 1960 o				\$200,000.00				1.000 <- %				11 \$9,000.00 \$200,000.00 \$6,000.00 \$15,000.00 \$191,000.00 \$200,000			
12 1960 o				\$100,000.00				1.000 <- %				12 \$9,000.00 \$100,000.00 \$3,000.00 \$12,000.00 \$91,000.00 \$100,000			
13 1960 o				\$10,300.00				1.000 <- %				13 \$9,000.00 \$10,300.00 \$309.00 \$9,309.00 \$1,300.00 \$10,300			
14 1960 o				\$10,000.00				5000.000 <- \$				14 \$5,000.00 \$10,000.00 \$300.00 \$5,300.00 \$5,000.00 \$10,000			
15 1960 o				\$7,725.00				5000.000 <- \$				15 \$5,000.00 \$7,725.00 \$231.75 \$5,231.75 \$2,725.00 \$7,725			
16 1960 o				\$7,500.00				5000.000 <- \$				16 \$5,000.00 \$7,500.00 \$225.00 \$5,225.00 \$2,500.00 \$7,500			
17 1960 o				\$5,000.00				0.999 Max				17 \$4,850.00 \$5,000.00 \$150.00 \$5,000.00 \$150.00 \$5,000			
18 1960 o				\$1,000.00				0.999 Max				18 \$970.00 \$1,000.00 \$30.00 \$1,000.00 \$30.00 \$1,000			
19 1960 n				\$10,000.00				1.000 <- %				19 \$9,000.00 \$10,000.00 \$300.00 \$9,300.00 \$1,000.00 \$10,000			
20 1960 n				\$10,000.00				1.000 <- %				20 \$9,000.00 \$10,000.00 \$300.00 \$9,300.00 \$1,000.00 \$10,000			
21 1950 . n				\$10,000.00				100.000 <- \$				21 \$100.00 \$10,000.00 \$100.00 \$10,000.00 \$9,900.00 \$10,000			
22 1950 . n				\$10,000.00				0.999 Max				22 \$10,000.00 \$10,000.00 \$300.00 \$10,300.00 \$11,000			
23 1950 . n				\$10,000.00				1.000 <- %				23 \$10,000.00 \$10,000.00 \$300.00 \$10,300.00 \$11,000			
24 1950 . n				\$10,000.00				1.000 <- %				24 \$10,000.00 \$10,000.00 \$300.00 \$10,300.00 \$11,000			
25 1950 . n				\$10,000.00				1.000 <- %				25 \$10,000.00 \$10,000.00 \$300.00 \$10,300.00 \$11,000			
26 1950 . n				\$10,000.00				1.000 <- %				26 \$10,000.00 \$10,000.00 \$300.00 \$10,300.00 \$11,000			

#2 _ _ _ _ _ A L T E R N A T I V E M A T C H I N G _ _ _ _ _				#3 _ _ _ _ _ N O N E L E C T I V E C O N T R I B U T I O N _ _ _ _ _			
				2.00% -- Statutory rate.		98.95% <- Owner % of Total E/er	
						93.17% <- Owner % of Nonelective	
>> OPTION NOT AVAILABLE IN 401(k)				401(k) S I M P L E		\$150,341.50 <- Owner Total	
						\$69,700.00 <- Nonowner Total	
						\$220,041.50 <- Plan Total	
						Net	
						IRC 415	
						401(k)	
						Limit	

(SIMPLE IRA, see Chapter 3)										2004				
#2 --- A L T E R N A T I V E M A T C H I N G ---					#3 --- N O N E L E C T I V E C O N T R I B U T I O N ---									
U P T O: 1.00%					2.00% -- Statutory rate.					98.98% <- Owner % of Total E/er				
S I M P L E I R A					S I M P L E I R A					>= \$5,000.05 <- Owner Total				
W-2 Income/					W-2 Income/					>= \$5,000.05 <- Owner Total				
.9235 NESE					.9235 NESE					>= \$5,000.05 <- Owner Total				
after					after 2% or					>= \$5,000.05 <- Owner Total				
Salary					Salary					>= \$5,000.05 <- Owner Total				
\$800.00					\$1,600.00					>= \$5,000.05 <- Owner Total				
Nonowner					Nonowner					>= \$5,000.05 <- Owner Total				
Matching					Matching					>= \$5,000.05 <- Owner Total				
Amounts					Amounts					>= \$5,000.05 <- Owner Total				
Total SIMPLE					Total SIMPLE					>= \$5,000.05 <- Owner Total				
Taxable					Taxable					>= \$5,000.05 <- Owner Total				
Income					Income					>= \$5,000.05 <- Owner Total				
#	\$212,413.49	\$1,264,157.87	\$12,641.58	\$225,055.07	#	\$215,413.49	\$1,424,157.88	\$22,186.56	\$237,600.05	#	\$215,413.49	\$1,424,157.88	\$22,186.56	\$237,600.05
1	\$10,500.00	\$276,877.26	\$2,768.77	\$13,268.77	\$263,608.49	1	\$10,500.00	\$276,877.26	\$4,100.00	\$14,600.00	\$262,277.26			
2	\$10,500.00	\$184,584.84	\$1,845.85	\$12,345.85	\$172,238.99	2	\$10,500.00	\$184,584.84	\$3,691.70	\$14,191.70	\$170,393.14			
3	\$10,500.00	\$92,292.42	\$922.92	\$11,422.92	\$80,869.50	3	\$10,500.00	\$92,292.42	\$1,845.85	\$12,345.85	\$79,946.57			
4	\$9,506.12	\$9,506.12	\$95.06	\$9,601.18	(\$95.06)	4	\$9,506.12	\$9,506.12	\$190.12	\$9,696.24	(\$190.12)			
5	\$9,229.24	\$9,229.24	\$92.29	\$9,321.53	(\$92.29)	5	\$9,229.24	\$9,229.24	\$184.58	\$9,413.82	(\$184.58)			
6	\$7,129.59	\$7,129.59	\$71.30	\$7,200.89	(\$71.30)	6	\$7,129.59	\$7,129.59	\$142.59	\$7,272.18	(\$142.59)			
7	\$6,921.93	\$6,921.93	\$69.22	\$6,991.15	(\$69.22)	7	\$6,921.93	\$6,921.93	\$138.44	\$7,060.37	(\$138.44)			
8	\$4,614.62	\$4,614.62	\$46.15	\$4,660.77	(\$46.15)	8	\$4,614.62	\$4,614.62		\$4,614.62				
9	\$922.92	\$922.92	\$9.23	\$932.15	(\$9.23)	9	\$922.92	\$922.92		\$922.92				
10	\$9,000.00	\$276,877.26	\$2,768.77	\$11,768.77	\$265,108.49	10	\$9,000.00	\$276,877.26	\$4,100.00	\$13,100.00	\$263,777.26			
11	\$9,000.00	\$184,584.84	\$1,845.85	\$10,845.85	\$173,738.99	11	\$9,000.00	\$184,584.84	\$3,691.70	\$12,691.70	\$171,893.14			
12	\$9,000.00	\$92,292.42	\$922.92	\$9,922.92	\$82,369.50	12	\$9,000.00	\$92,292.42	\$1,845.85	\$10,845.85	\$81,446.57			
13	\$9,000.00	\$9,506.12	\$95.06	\$9,095.06	\$411.06	13	\$9,000.00	\$9,506.12	\$190.12	\$9,190.12	\$316.00			
14	\$9,000.00	\$9,229.24	\$92.29	\$9,092.29	\$136.95	14	\$9,000.00	\$9,229.24	\$184.58	\$9,184.58	\$44.66			
15	\$7,129.59	\$7,129.59	\$71.30	\$7,200.89	(\$71.30)	15	\$7,129.59	\$7,129.59	\$142.59	\$7,272.18	(\$142.59)			
16	\$6,921.93	\$6,921.93	\$69.22	\$6,991.15	(\$69.22)	16	\$6,921.93	\$6,921.93	\$138.44	\$7,060.37	(\$138.44)			
17	\$4,614.62	\$4,614.62	\$46.15	\$4,660.77	(\$46.15)	17	\$4,614.62	\$4,614.62		\$4,614.62				
18	\$922.92	\$922.92	\$9.23	\$932.15	(\$9.23)	18	\$922.92	\$922.92		\$922.92				
19	\$9,000.00	\$10,000.00	\$100.00	\$9,100.00	\$1,000.00	19	\$9,000.00	\$30,000.00	\$200.00	\$9,200.00	\$21,000.00			
20	\$9,000.00	\$10,000.00	\$100.00	\$9,100.00	\$1,000.00	20	\$9,000.00	\$30,000.00	\$200.00	\$9,200.00	\$21,000.00			
21	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		21	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			
22	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		22	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			
23	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		23	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			
24	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		24	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			
25	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		25	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			
26	\$10,000.00	\$10,000.00	\$100.00	\$10,100.00		26	\$10,500.00	\$30,000.00	\$200.00	\$10,700.00	\$19,500.00			

401(k) SIMPLE Plan for a Partnership

(401(k) SIMPLE, see Chapter 3)										SIMPLE ILLUSTRATOR										16-Feb-2004									
401(k) SIMPLE										#1 --- MATCHING CONTRIBUTION ---																			
2004 <- Plan Year										P Entity Type (C, P, or S)										UP TO 3%									
3.00% <- General Matching										C = Corporation										97.35% <- Owner % of Total R/er									
1.00% <- Alt. Matching - N/A										P = Partnership or LLC										88.00% <- Owner % of Matching									
K <- 401(k) SIMPLE										S = Sole-Proprietorship										401(k) SIMPLE									
Y <- Catch-Up										Take Home										W-2 Income/									
																				.9235 NESE									
																				after 3% or									
																				\$206,220.58 <- Plan Total									
																				Net									
All Partners										Year										Owner									
And Eligible										of										Enter									
Employees										Birth										"o"									

(401(k) SIMPLE, see Chapter 3)										2004
#2 _ _ _ _ ALTERNATIVE MATCHING _ _ _ _ _					#3 _ _ _ _ NONELECTIVE CONTRIBUTION _ _ _ _ _					
>> OPTION NOT AVAILABLE IN 401(k)					2.)					
					98.06% <- Owner % of Total E/er					
					87.66% <- Owner % of Nonelective					
					401(k) SIMPLE					
					W-2 Income/	\$146,246.51	<- Owner Total			
					.9235 NESE	\$48,900.00	<- Nonowner Total			
					after 2% or	\$195,146.51	<- Plan Total			
					Salary	\$2,900.00	\$5,000.00	<- Min. Comp.	Net	
					Reduction				IRC 415	
					Contribution	Nonowner	Non-Elective	Total SIMPLE	Taxable 401(k)	
						Allocation	Contribution	Contribution	Income Limit	
#					\$171,652.21	\$1,619,896.68	\$23,494.30	\$195,146.51		
1					\$10,500.00	\$277,050.00	\$4,100.00	\$14,600.00	\$262,450.00 \$205,000	
2					\$10,500.00	\$184,700.00	\$3,694.00	\$14,194.00	\$170,506.00 \$186,200	
3					\$10,500.00	\$92,350.00	\$1,847.00	\$12,347.00	\$80,003.00 \$93,850	
4					\$9,512.05	\$9,512.05	\$190.24	\$9,702.29	(\$190.24) \$10,024	
5					\$1,000.00	\$9,235.00	\$184.70	\$1,184.70	\$8,050.30 \$9,235	
6					\$6,991.36	\$7,134.04	\$142.68	\$7,134.04	\$7,134	
7					\$6,787.73	\$6,926.25	\$138.53	\$6,926.26	(\$0.01) \$6,926	
8					\$4,617.50	\$4,617.50		\$4,617.50	\$4,618	
9					\$923.50	\$923.50		\$923.50	\$924	
10					\$9,000.00	\$277,050.00	\$4,100.00	\$13,100.00	\$263,950.00 \$205,000	
11					\$9,000.00	\$184,700.00	\$3,694.00	\$12,694.00	\$172,006.00 \$184,700	
12					\$9,000.00	\$92,350.00	\$1,847.00	\$10,847.00	\$81,503.00 \$92,350	
13					\$9,000.00	\$9,512.05	\$190.24	\$9,190.24	\$321.81 \$9,512	
14					\$9,000.00	\$9,235.00	\$184.70	\$9,184.70	\$50.30 \$9,235	
15					\$6,991.36	\$7,134.04	\$142.68	\$7,134.04	\$7,134	
16					\$6,787.73	\$6,926.25	\$138.53	\$6,926.26	(\$0.01) \$6,926	
17					\$4,617.50	\$4,617.50		\$4,617.50	\$4,618	
18					\$923.50	\$923.50		\$923.50	\$924	
19					\$9,000.00	\$60,000.00	\$400.00	\$9,400.00	\$51,000.00 \$60,000	
20					\$10,500.00	\$60,000.00	\$400.00	\$10,900.00	\$49,500.00 \$61,500	
21					\$10,500.00	\$60,000.00	\$400.00	\$10,900.00	\$49,500.00 \$61,500	
22					\$10,500.00	\$60,000.00	\$400.00	\$10,900.00	\$49,500.00 \$61,500	
23					\$2,000.00	\$60,000.00	\$400.00	\$2,400.00	\$58,000.00 \$60,000	
24					\$1,000.00	\$60,000.00	\$400.00	\$1,400.00	\$59,000.00 \$60,000	
25					\$500.00	\$60,000.00	\$400.00	\$900.00	\$59,500.00 \$60,000	
26					\$2,000.00	\$15,000.00	\$100.00	\$2,100.00	\$13,000.00 \$15,000	

* DARN KNOT SHOP (See chapter 7: Non-Integrated) *

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04-Feb-2004

* CORPORATE PROFIT-SHARING PLAN *

05:30 PM

* NON-INTEGRATED CONTRIBUTIONS

* * A L L O C A T I O N O F D E S I R E D C O N T R I B U T I O N * *

* * I N T E G R A T I O N M E T H O D : N O T I N T E G R A T E D * *

EMPLOYEES	2004 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 24.848482% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF	EXCESS COMPENSATION MULTIPLIED BY DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
Lorenzo Darn	\$165,000.00	\$41,000.00	\$165,000.00		\$41,000.00
Asia Darn	\$100,000.00	\$24,848.48	\$100,000.00		\$24,848.48
Beatrice Darn	\$50,000.00	\$12,424.24	\$50,000.00		\$12,424.24
	\$315,000.00	\$78,272.72	\$315,000.00		\$78,272.72
Donna Harp	\$50,000.00	\$12,424.24	\$50,000.00		\$12,424.24
Clara Knott	\$40,000.00	\$9,939.39	\$40,000.00		\$9,939.39
Joe Franklyn	\$30,000.00	\$7,454.54	\$30,000.00		\$7,454.54
	\$120,000.00	\$29,818.18	\$120,000.00		\$29,818.18
	\$435,000.00	\$108,090.90	\$435,000.00		\$108,090.90

* CORPORATE PROFIT-SHARING PLAN *

* DARN KNOT SHOP (See chapter 7: Integration Level - \$1) *

* QP-SEP Illustration

1 of 2

* Prepared by: Marvin Mantel, CPA

05:35 PM

04-Feb-2004

Plan Year Beginning: 2004 ALL - Employer Contribution
 Base Percentage: 19.1485170 \$108,090.71 - DEDUCTIBLE PORTION
 Integration Level: \$1 24.848438379% - Total Contributions
 Excess Percentage: 24.8485170 5.7% - Allocation % of Deduction Comp
 1=P/S 2=MP 3=SEP 4=SARSEP: 1 - Maximum Integration Spread
 E/er Contr. to Owners: 72.41386402%
 E/er Alloc. Compensation: 72.41379310% \$41,000.00 - Maximum Allocation

					DEDUCTION			
-> Plan not T/H	TOTAL	ALLOCATION %	(1)	Columns reserved for	K	EMPLOYEE's	COMPENSATION	
P Integrated Prototype Plan	ALLOCATION	OF DEDUCTION	EMPLOYER	Salary Reduction SEPs	E	PRE-PLAN	Col N/A	-Includes-
	(1 + 2)	COMPENSATION	CONTRIBUTION		Y	EARNED INCOME	for PS & MP	-Elective-
1	Lorenzo Darn	\$41,000.00	24.848482%	\$41,000.00	Y	\$165,000.00	\$165,000.00	\$165,000.00
2	Asia Darn	\$24,848.46	24.848460%	\$24,848.46	Y	\$100,000.00	\$100,000.00	\$100,000.00
3	Beatrice Darn	\$12,424.20	24.848403%	\$12,424.20	Y	\$50,000.00	\$50,000.00	\$50,000.00
4								
5								
6								
7								
8								
	OWNER SUB-TOTALS	\$78,272.66		\$78,272.66		\$315,000.00	\$315,000.00	\$315,000.00
9	Donna Harp	\$12,424.20	24.848403%	\$12,424.20	N	\$50,000.00	\$50,000.00	\$50,000.00
10	Clara Knott	\$9,939.35	24.848375%	\$9,939.35	N	\$40,000.00	\$40,000.00	\$40,000.00
11	Joe Franklyn	\$7,454.50	24.848327%	\$7,454.50	N	\$30,000.00	\$30,000.00	\$30,000.00
12								
13								
14								
15								
16								
17								
18								
	NON-OWNER SUB TOTALS	\$29,818.05		\$29,818.05		\$120,000.00	\$120,000.00	\$120,000.00
	GRAND TOTALS	\$108,090.71		\$108,090.71		\$435,000.00	\$435,000.00	\$435,000.00

* DARN KNIT SHOP (See chapter 7: Integration Level - \$1) *						2 of 2
* CORPORATE PROFIT-SHARING PLAN *						04-Feb-2004
* INTEGRATED CONTRIBUTIONS						05:35 PM
* * A L L O C A T I O N O F D E S I R E D C O N T R I B U T I O N * *						
* * I N T E G R A T I O N M E T H O D : I R S P E R C E N T A G E M E T H O D * *						
EMPLOYEES	2004 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 19.148517% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$1.00	EXCESS COMPENSATION MULTIPLIED BY 5.700000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT	
Lorenzo Darn	\$165,000.00	\$31,595.05	\$164,999.00	\$9,404.94	\$41,000.00	
Asia Darn	\$100,000.00	\$19,148.52	\$99,999.00	\$5,699.94	\$24,848.46	
Beatrice Darn	\$50,000.00	\$9,574.26	\$49,999.00	\$2,849.94	\$12,424.20	
	\$315,000.00	\$60,317.83	\$314,997.00	\$17,954.83	\$78,272.66	
Donna Harp	\$50,000.00	\$9,574.26	\$49,999.00	\$2,849.94	\$12,424.20	
Clara Knott	\$40,000.00	\$7,659.41	\$39,999.00	\$2,279.94	\$9,939.35	
Joe Franklyn	\$30,000.00	\$5,744.56	\$29,999.00	\$1,709.94	\$7,454.50	
	\$120,000.00	\$22,978.22	\$119,997.00	\$6,839.83	\$29,818.05	
	\$435,000.00	\$83,296.05	\$434,994.00	\$24,794.66	\$108,090.71	

* CORPORATE PROFIT-SHARING PLAN *		* DARN KNIT SHOP (See chapter 7: Integration Level - 20% of TWB) *		* QP-SEP Illustrator		1 of 2
				* Prepared by: Marvin Mantel, CPA		05:39 PM
						04-Feb-2004
Plan Year Beginning:	2004	\$104,720.33	- Employer Contribution			
Base Percentage:	19.7557910	ALL	- DEDUCTIBLE PORTION			
Integration Level:	\$17,580	\$104,720.33	- Total Contributions			
Excess Percentage:	25.4557910	24.073639276%	- Allocation % of Deduction Comp			
1=P/S 2=MP 3=SEP 4=SARSEP:	1	5.7%	- Maximum Integration Spread			
E/er Contr. to Owners:	73.70064726%					
E/er Alloc. Compensation:	72.41379310%	\$41,000.00	- Maximum Allocation			
-> Plan not T/H	TOTAL	ALLOCATION %	(1)	Columns reserved for	K	DEDUCTION
P Integrated Prototype Plan	ALLOCATION	OF DEDUCTION	EMPLOYER	Salary Reduction SEPs	E Col	COMPENSATION
	(1 + 2)	COMPENSATION	CONTRIBUTION		Y n/a	-Includes-
						-Elective-
1	Lorenzo Darn	\$41,000.00	24.848482%	\$41,000.00	Y	\$165,000.00
2	Asia Darn	\$24,453.73	24.453731%	\$24,453.73	Y	\$100,000.00
3	Beatrice Darn	\$11,725.84	23.451671%	\$11,725.84	Y	\$50,000.00
4						
5						
6						
7						
8						
	OWNER SUB-TOTALS	\$77,179.56		\$77,179.56		\$315,000.00
						\$315,000.00
						\$315,000.00
9	Donna Harp	\$11,725.84	23.451671%	\$11,725.84	N	\$50,000.00
10	Clara Knott	\$9,180.26	22.950641%	\$9,180.26	N	\$40,000.00
11	Joe Franklyn	\$6,634.68	22.115591%	\$6,634.68	N	\$30,000.00
12						
13						
14						
15						
16						
17						
18						
	NON-OWNER SUB TOTALS	\$27,540.77		\$27,540.77		\$120,000.00
						\$120,000.00
						\$120,000.00
	GRAND TOTALS	\$104,720.33		\$104,720.33		\$435,000.00
						\$435,000.00
						\$435,000.00

* DARN KNIT SHOP (See chapter 7: Integration Level - 20% of TWB) *

2 of 2

* CORPORATE PROFIT-SHARING PLAN *

04-Feb-2004

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* INTEGRATED CONTRIBUTIONS *

* * ALLOCATION OF DESIRED CONTRIBUTION * *

* * INTEGRATION METHOD: IRS PERCENTAGE METHOD * *

EMPLOYEES	2004 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 19.755791% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$17,580.00	EXCESS COMPENSATION MULTIPLIED BY 5.700000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
Lorenzo Darn	\$165,000.00	\$32,597.06	\$147,420.00	\$8,402.94	\$41,000.00
Asia Darn	\$100,000.00	\$19,755.79	\$82,420.00	\$4,697.94	\$24,453.73
Beatrice Darn	\$50,000.00	\$9,877.90	\$32,420.00	\$1,847.94	\$11,725.84
	\$315,000.00	\$62,230.74	\$262,260.00	\$14,948.82	\$77,179.56
Donna Harp	\$50,000.00	\$9,877.90	\$32,420.00	\$1,847.94	\$11,725.84
Clara Knott	\$40,000.00	\$7,902.32	\$22,420.00	\$1,277.94	\$9,180.26
Joe Franklyn	\$30,000.00	\$5,926.74	\$12,420.00	\$707.94	\$6,634.68
	\$120,000.00	\$23,706.95	\$67,260.00	\$3,833.82	\$27,540.77
	\$435,000.00	\$85,937.69	\$329,520.00	\$18,782.64	\$104,720.33

* CORPORATE PROFIT-SHARING PLAN *

* DARN KNIT SHOP (See chapter 7: Integration Level - 80% of TWB + \$1)

* QP-SEP Illustrator

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* Prepared by: Marvin Mantel, CPA

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04-Feb-2004

Plan Year Beginning:	2004	\$101,327.38	- Employer Contribution							
Base Percentage:	21.7498970	\$101,327.38	- DEDUCTIBLE PORTION							
Integration Level:	\$70,321	23.293651483%	- Total Contributions							
Excess Percentage:	27.1498970	5.4%	- Allocation % of Deduction Comp							
1=P/S 2=MP 3=SEP 4=SARSEP:	1		- Maximum Integration Spread							
E/er Contr. to Owners:	74.24203075%									
E/er Alloc. Compensation:	72.41379310%	\$41,000.00	- Maximum Allocation							
-> Plan not T/H	TOTAL	ALLOCATION %	(1)	Columns reserved for	K	EMPLOYEE'S	DEDUCTION			
P Integrated Prototype Plan	ALLOCATION	OF DEDUCTION	EMPLOYER	Salary Reduction SEPs	E Col	PRE-PLAN	COMPENSATION			
	(1 + 2)	COMPENSATION	CONTRIBUTION		Y n/a	EARNED INCOME	-Includes-			
							-Elective-			
1	Lorenzo Darn	\$41,000.00	24.848482%	\$41,000.00	Y	\$165,000.00	\$165,000.00	\$165,000.00		
2	Asia Darn	\$23,352.56	23.352563%	\$23,352.56	Y	\$100,000.00	\$100,000.00	\$100,000.00		
3	Beatrice Darn	\$10,874.95	21.749897%	\$10,874.95	Y	\$50,000.00	\$50,000.00	\$50,000.00		
4										
5										
6										
7										
8										
	OWNER SUB-TOTALS	\$75,227.51		\$75,227.51		\$315,000.00	\$315,000.00	\$315,000.00		
9	Donna Harp	\$10,874.95	21.749897%	\$10,874.95	N	\$50,000.00	\$50,000.00	\$50,000.00		
10	Clara Knott	\$8,699.96	21.749897%	\$8,699.96	N	\$40,000.00	\$40,000.00	\$40,000.00		
11	Joe Franklyn	\$6,524.97	21.749897%	\$6,524.97	N	\$30,000.00	\$30,000.00	\$30,000.00		
12										
13										
14										
15										
16										
17										
18										
	NON-OWNER SUB TOTALS	\$26,099.88		\$26,099.88		\$120,000.00	\$120,000.00	\$120,000.00		
	GRAND TOTALS	\$101,327.38		\$101,327.38		\$435,000.00	\$435,000.00	\$435,000.00		

* DARN KNIT SHOP (See chapter 7: Integration Level - 80% of TWB * \$1

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04-Feb-2004

* CORPORATE PROFIT-SHARING PLAN *

05:50 PM

* INTEGRATED CONTRIBUTIONS

* * ALLOCATION OF DESIRED CONTRIBUTION * *

* * INTEGRATION METHOD: IRS PERCENTAGE METHOD * *

EMPLOYEES	2004 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 21.749897% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$70,321.00	EXCESS COMPENSATION MULTIPLIED BY 5.400000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
Lorenzo Darn	\$165,000.00	\$35,887.33	\$94,679.00	\$5,112.67	\$41,000.00
Asia Darn	\$100,000.00	\$21,749.90	\$29,679.00	\$1,602.67	\$23,352.56
Beatrice Darn	\$50,000.00	\$10,874.95			\$10,874.95
	\$315,000.00	\$68,512.18	\$124,358.00	\$6,715.33	\$75,227.51
Donna Harp	\$50,000.00	\$10,874.95			\$10,874.95
Clara Knott	\$40,000.00	\$8,699.96			\$8,699.96
Joe Franklyn	\$30,000.00	\$6,524.97			\$6,524.97
	\$120,000.00	\$26,099.88			\$26,099.88
	\$435,000.00	\$94,612.05	\$124,358.00	\$6,715.33	\$101,327.38

* CORPORATE PROFIT-SHARING PLAN *

* DARN KNIT SHOP (See chapter 7: Integration Level - 100% of TWB)

* QP-SEP Illustration

1 of 2

* Prepared by: Marvin Mantel, CPA

05:52 PM

04-Feb-2004

Plan Year Beginning:	2004	ALL	- Employer Contribution						
Base Percentage:	22.1850280	\$101,589.27	- DEDUCTIBLE PORTION						
Integration Level:	\$87,900	23.353855586%	- Total Contributions						
Excess Percentage:	27.8850280	5.7%	- Allocation % of Deduction Comp						
1=P/S 2=MP 3=SEP 4=SARSEP:	1		- Maximum Integration Spread						
E/er Contr. to Owners:	73.79444391%								
E/er Alloc. Compensation:	72.41379310%	\$41,000.00	- Maximum Allocation						
-> Plan not T/H	TOTAL	ALLOCATION %	(1)	Columns reserved for	K	EMPLOYEE's	DEDUCTION		
P Integrated Prototype Plan	ALLOCATION	OF DEDUCTION	EMPLOYER	Salary Reduction SEPS	E Col	PRE-PLAN	COMPENSATION		
	(1 + 2)	COMPENSATION	CONTRIBUTION		Y n/a	EARNED INCOME	Col N/A	-Includes-	
							for PS & MP	-Elective-	
1	Lorenzo Darn	\$41,000.00	24.848483%	\$41,000.00	Y	\$165,000.00	\$165,000.00	\$165,000.00	
2	Asia Darn	\$22,874.73	22.874728%	\$22,874.73	Y	\$100,000.00	\$100,000.00	\$100,000.00	
3	Beatrice Darn	\$11,092.51	22.185028%	\$11,092.51	Y	\$50,000.00	\$50,000.00	\$50,000.00	
4									
5									
6									
7									
8									
OWNER SUB-TOTALS	\$74,967.24			\$74,967.24		\$315,000.00	\$315,000.00	\$315,000.00	
9	Donna Harp	\$11,092.51	22.185028%	\$11,092.51	N	\$50,000.00	\$50,000.00	\$50,000.00	
10	Clara Knott	\$8,874.01	22.185028%	\$8,874.01	N	\$40,000.00	\$40,000.00	\$40,000.00	
11	Joe Franklyn	\$6,655.51	22.185028%	\$6,655.51	N	\$30,000.00	\$30,000.00	\$30,000.00	
12									
13									
14									
15									
16									
17									
18									
NON-OWNER SUB TOTALS	\$26,622.03			\$26,622.03		\$120,000.00	\$120,000.00	\$120,000.00	
GRAND TOTALS	\$101,589.27			\$101,589.27		\$435,000.00	\$435,000.00	\$435,000.00	

* DARN KNIT SHOP (See chapter 7: Integration Level - 100% of TWB)						2 of 2
* CORPORATE PROFIT-SHARING PLAN *						04-Feb-2004
* INTEGRATED CONTRIBUTIONS						05:52 PM
** ALLOCATION OF DESIRED CONTRIBUTION **						
** INTEGRATION METHOD: IRS PERCENTAGE METHOD **						
EMPLOYEES	2004 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 22.185028% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$87,900.00	EXCESS COMPENSATION MULTIPLIED BY 5.700000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT	
Lorenzo Darn	\$165,000.00	\$36,605.30	\$77,100.00	\$4,394.70	\$41,000.00	
Asia Darn	\$100,000.00	\$22,185.03	\$12,100.00	\$689.70	\$22,874.73	
Beatrice Darn	\$50,000.00	\$11,092.51			\$11,092.51	
	\$315,000.00	\$69,882.84	\$89,200.00	\$5,084.40	\$74,967.24	
Donna Harp	\$50,000.00	\$11,092.51			\$11,092.51	
Clara Knott	\$40,000.00	\$8,874.01			\$8,874.01	
Joe Franklyn	\$30,000.00	\$6,655.51			\$6,655.51	
	\$120,000.00	\$26,622.03			\$26,622.03	
	\$435,000.00	\$96,504.87	\$89,200.00	\$5,084.40	\$101,589.27	

Money-Purchase Plan

* MONEY PURCHASE KEOGH PLAN *		* UNUSUAL FACT PATTERN (showing reductions to earned income) *		QP-SEP Illustration		1
				Prepared for: Sharon A. Marmelstein (SAM)		03:45 PM
						02-Mar-2004
Plan Year Beginning:	2004	\$137,554.64	- Employer Contribution			
Base Percentage:	20.0000000	ALL	- DEDUCTIBLE PORTION			
Integration Level:	\$0	\$137,554.64	- Total Contributions			
Excess Percentage:	20.0000000	19.999999990%	- Allocation % of Ded. Comp.			
1=P/S 2=MP 3=SEP 4=SARSEP:	2	None	- Integration			
E/er Contr. to Owners:	85.46%					
E/er Alloc. Compensation:	85.46%	\$41,000.00	- Maximum Allocation			
-> Plan not T/H		TOTAL	ALLOCATION %	(1)	Columns reserved for	DEDUCTION
P	Prototype Plan	ALLOCATION	OF DEDUCTION	EMPLOYER	Salary Reduction SEPs	COMPENSATION
	(1 + 2)	COMPENSATION	CONTRIBUTION			-Includes-
						-Elective-
1	Mary Unusual	\$41,000.00	20.000000%	\$41,000.00	Y	\$500,000.00 Y \$0.00 \$205,000.00
2	Bob: Also has W-2 income	\$15,309.65	20.000000%	\$15,309.65	Y	\$100,000.00 Y \$0.00 \$76,548.26
3	Tom: Has outside SE loss	\$15,297.17	20.000000%	\$15,297.17	Y	\$100,000.00 Y \$0.00 \$76,485.83
4	Morra Unusual	\$15,206.32	20.000000%	\$15,206.32	Y	\$100,000.00 Y \$0.00 \$76,031.59
5	John Bossman III	\$15,206.32	20.000000%	\$15,206.32	Y	\$100,000.00 Y \$0.00 \$76,031.59
6	Sue: Guaranteed Pmt Ptn	\$15,535.19	20.000000%	\$15,535.19	Y	\$100,000.00 Y \$0.00 \$77,675.94
7	Bo: \$100k, ineligible, but	\$0.00	0.000000%	\$0.00	Y	\$0.00 Y \$0.00 \$0.00
8	shares in CLE plan expense	\$0.00	0.000000%	\$0.00	Y	\$0.00 Y \$0.00 \$0.00
	OWNER SUB-TOTALS	\$117,554.64		\$117,554.64		\$1,000,000.00 \$0.00 \$587,773.20
9	Stanly Goldstein	\$6,666.67	20.000000%	\$6,666.67	N	\$33,333.33 N \$33,333.33 \$33,333.33
10	Harry Rose	\$6,666.67	20.000000%	\$6,666.67	N	\$33,333.33 N \$33,333.33 \$33,333.33
11	Leon Schneider	\$6,666.67	20.000000%	\$6,666.67	N	\$33,333.33 N \$33,333.33 \$33,333.33
12		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
13		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
14		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
15		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
16		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
17		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
18		\$0.00	0.000000%	\$0.00	N	\$0.00 N \$0.00 \$0.00
	NON-OWNER SUB TOTALS	\$20,000.00		\$20,000.00		\$100,000.00 \$100,000.00 \$100,000.00
	GRAND TOTALS	\$137,554.64		\$137,554.64		\$1,100,000.00 \$100,000.00 \$687,773.20

* UNUSUAL FACT PATTERN (showing reductions to earned income) *

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02-Mar-2004

* MONEY PURCHASE KEOGH PLAN *

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* * SPECIAL SITUATION INPUT PAGE * *

* NON-INTEGRATED CONTRIBUTIONS

		SUBTRACTIONS FOR OWNER'S NET COMPENSATION		Sum of:		(3)		(4)		TOP HEAVY ADDITIONAL
ALLOCATION	M	a	OWNERS	1-E/er Contrib.	2-Non C-U Elect	ADDITIONAL	NON-OWNER	COMPENSATION	TOTAL	PRO-RATA
COMPENSATION	CALCULATE	n	SHARE	3-Share of E/ee	GAIN (LOSS)	CONTRIBUTIONS	CONTRIBUTIONS	FOR S-E TAX	W-2 WAGES	S-E TAX
-Includes-	OWNER'S			4-50% of SE Tax	FOR S-E TAX	ALLOCATED	PURPOSES	FOR S-E TAX	DEDUCTION	AMOUNT FOR
-Elective-	PERCENTAGE	1	PERCENTAGE							PERCENTAGE
\$205,000.00	50.0000%		50.00000%	\$63,011.27	\$0.00	\$10,000.00	\$490,000.00	\$0.00	\$12,011.27	\$0.00
\$76,548.26	10.0000%		10.00000%	\$23,451.74	\$0.00	\$2,000.00	\$98,000.00	\$10,000.00	\$6,142.09	\$0.00
\$76,485.83	10.0000%		10.00000%	\$23,514.17	(\$10,000.00)	\$2,000.00	\$88,000.00	\$0.00	\$6,217.00	\$0.00
\$76,031.59	10.0000%		10.00000%	\$23,968.41	\$0.00	\$2,000.00	\$98,000.00	\$0.00	\$6,762.09	\$0.00
\$76,031.59	10.0000%		10.00000%	\$23,968.41	\$0.00	\$2,000.00	\$98,000.00	\$0.00	\$6,762.09	\$0.00
\$77,675.94	0.0000%	?	0.00000%	\$22,324.06	\$0.00	\$0.00	\$100,000.00	\$0.00	\$6,788.88	\$0.00
\$0.00	10.0000%	?	10.00000%	\$2,000.00	\$0.00	\$2,000.00	\$0.00	\$0.00	\$0.00	\$0.00
\$0.00	0.0000%		0.00000%	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
\$587,773.20	100.0000%		SUB-TOTALS	\$182,238.07	(\$10,000.00)	\$20,000.00	\$972,000.00	\$10,000.00	\$44,683.43	\$0.00
\$33,333.33	Ownership percentages are--									\$0.00
\$33,333.33	being set manually and total 100%.									\$0.00
\$33,333.33										\$0.00
\$0.00	Additional amounts (contributions/accounts/gains), if any, entered									\$0.00
\$0.00	in last column (this page) are considered for Top-Heavy Analysis.									\$0.00
\$0.00										\$0.00
\$0.00	KEY-EMPLOYEE TOP-HEAVY ANALYSIS--									\$0.00
\$0.00	- Key Employee Accounts/Contributions:									\$0.00
\$0.00	- Non-Key Employee Accounts/Contributions:									\$0.00
\$0.00	- - Total Accounts/Contributions:									\$0.00
\$100,000.00										\$0.00
\$687,773.20										\$0.00

* UNUSUAL FACT PATTERN (showing reductions to earned income) *

\$137,554.64 - Employer Contribution

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ALL - DEDUCTIBLE PORTION

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* MONEY PURCHASE KEOGH PLAN *

\$137,554.64 - Total Contributions

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20.00% - Allocation % of Ded. Comp.

None - Integration

2004

* * CONTRIBUTION SUMMARY * *

None - Integration Level Percentage of TWB: n/a

		PRE-PLAN		TOTAL		EMPLOYER'S		BASIC		CATCH-UP		ULTRA NET		EMPLOYER		PERCENTAGE		PERCENTAGE	
EMPLOYEE	COMPENSATION	ALLOCATION	CONTRIBUTION	ELECTIVE	CONTRIBUTION	COMPENSATION	TAXABLE	CONTRIBUTION	CONTRIBUTIONS	CONTRIBUTIONS	CONTRIBUTIONS	CONTRIBUTIONS	CONTRIBUTIONS	% OF DEDUCT.	% OF DEDUCT.	OF EMPLOYER	OF EMPLOYER	OF TOTAL	OF TOTAL
Mary Unusual	\$500,000.00	\$41,000.00	\$41,000.00	n/a	n/a	\$446,988.73		20.00%	29.81%	29.81%									
Bob: Also has W-2 income	\$100,000.00	\$15,309.65	\$15,309.65	n/a	n/a	\$78,548.26		20.00%	11.13%	11.13%									
Tom: Has outside SE loss	\$100,000.00	\$15,297.17	\$15,297.17	n/a	n/a	\$78,485.83		20.00%	11.12%	11.12%									
Morra Unusual	\$100,000.00	\$15,206.32	\$15,206.32	n/a	n/a	\$78,031.59		20.00%	11.05%	11.05%									
John Bossman III	\$100,000.00	\$15,206.32	\$15,206.32	n/a	n/a	\$78,031.59		20.00%	11.05%	11.05%									
Sue: Guaranteed Pmt Ptn	\$100,000.00	\$15,535.19	\$15,535.19	n/a	n/a	\$77,675.94		20.00%	11.29%	11.29%									
Bo: \$100k, ineligible, bu	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
shares in CLE plan expens	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
OWNER SUB-TOTALS	\$1,000,000.00	\$117,554.64	\$117,554.64													85.46%	85.46%		
Stanly Goldstein	\$33,333.33	\$6,666.67	\$6,666.67	n/a	n/a	\$33,333.33		20.00%	4.85%	4.85%									
Harry Rose	\$33,333.33	\$6,666.67	\$6,666.67	n/a	n/a	\$33,333.33		20.00%	4.85%	4.85%									
Leon Schneider	\$33,333.33	\$6,666.67	\$6,666.67	n/a	n/a	\$33,333.33		20.00%	4.85%	4.85%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
	\$0.00	\$0.00	\$0.00	n/a	n/a	\$0.00		0.00%	0.00%	0.00%									
NON-OWNER SUB TOTALS	\$100,000.00	\$20,000.00	\$20,000.00													14.54%	14.54%		
GRAND TOTALS	\$100,000.00	\$137,554.64	\$137,554.64													100.0%	100.0%		

* UNUSUAL FACT PATTERN (showing reductions to earned income) *					4
					02-Mar-2004
* MONEY PURCHASE KEOGH PLAN *					03:45 PM
* NON-INTEGRATED CONTRIBUTIONS	** ALLOCATION OF DESIRED CONTRIBUTION **				
	** INTEGRATION METHOD: NOT INTEGRATED **				
EMPLOYEES	PLAN ALLOCATION		EXCESS COMPENSATION		UNLIMITED TOTAL PLAN DEPOSIT
	2004 ALLOCATION COMPENSATION	COMPENSATION MULTIPLIED BY 20.000000% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$0.00	MULTIPLIED BY 0.000000% DISPARITY RATE	
Mary Unusual	\$205,000.00	\$41,000.00	\$205,000.00	\$0.00	\$41,000.00
Bob: Also has W-2 income	\$76,548.26	\$15,309.65	\$76,548.26	\$0.00	\$15,309.65
Tom: Has outside SE loss	\$76,485.83	\$15,297.17	\$76,485.83	\$0.00	\$15,297.17
Morra Unusual	\$76,031.59	\$15,206.32	\$76,031.59	\$0.00	\$15,206.32
John Bossman III	\$76,031.59	\$15,206.32	\$76,031.59	\$0.00	\$15,206.32
Sue: Guaranteed Pmt Ptn	\$77,675.94	\$15,535.19	\$77,675.94	\$0.00	\$15,535.19
Bo: \$100k, ineligible, but shares in CLE plan expense	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$587,773.20	\$117,554.64	\$587,773.20	\$0.00	\$117,554.64
Stanly Goldstein	\$33,333.33	\$6,666.67	\$33,333.33	\$0.00	\$6,666.67
Harry Rose	\$33,333.33	\$6,666.67	\$33,333.33	\$0.00	\$6,666.67
Leon Schneider	\$33,333.33	\$6,666.67	\$33,333.33	\$0.00	\$6,666.67
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$100,000.00	\$20,000.00	\$100,000.00	\$0.00	\$20,000.00
	\$687,773.20	\$137,554.64	\$687,773.20	\$0.00	\$137,554.64

[illegible]

Appendix C

Employee Benefits Limits

Indexing of Employee Benefit Limits

Many of the dollar thresholds used in limiting the level of benefits available through tax-advantaged programs are adjusted to reflect changes in the consumer price index (CPI) relative to the base period used for each limit. The limit for a particular year is adjusted based on the cumulative increase through the third quarter of the preceding calendar year. The adjusted limits are then rounded down to the nearest multiplier specified for the particular limit. The limits for 2005, for example, are based on the CPI factors through the third quarter of 2004. Estimated changes for 2005 based on the CPI through January 2004 are shown in the following table.

A change of about 1.3 percent through September 2004 would be required before any of the limits move up further; defined-contribution annual addition to \$42,000, highly compensated employee (HCE) threshold to \$95,000, and the compensation limit to \$210,000.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) overrides many of the pre-EGTRRA CPI adjustments with specific increases over a five-year period before CPI increases restart for items with fixed increments. The following table shows that the fixed limits will be through 2006 for the limits modified by EGTRRA.

Indexing of Employee Benefit Limits

Purpose	Calendar Year			
	2003	2004	2005	2006
Base 402(g) deferral limit	\$ 12,000	\$ 13,000	\$ 14,000	\$15,000
457 limit	\$ 12,000	\$ 13,000	\$ 14,000	\$15,000
401(k)/403(b)/457/SARSEP, ¹ catch-up deferrals	\$ 2,000	\$ 3,000	\$ 4,000	\$ 5,000
SIMPLE limit	\$ 8,000	\$ 9,000	\$ 10,000	
SIMPLE catch-up deferrals	\$ 1,000	\$ 1,500	\$ 2,000	\$ 2,500
IRA/Roth-IRA limit	\$ 3,000	\$ 3,000	\$ 4,000	\$ 4,000
IRA/Roth-IRA catch-up contributions	\$ 500	\$ 500	\$ 500	\$ 1,000
DB ² maximum benefit	\$160,000	\$165,000	\$165,000*	
DC ³ maximum addition	\$ 40,000	\$ 41,000	\$ 41,000*	
HCE compensation ⁴	\$ 90,000	\$ 90,000	\$ 90,000*	
Key employee:				
Officer ⁵	\$130,000	\$130,000	\$135,000*	
1% Owners	\$150,000	\$150,000	\$150,000	
Compensation ⁶	\$200,000	\$205,000	\$205,000*	
SEP threshold	\$ 450	\$ 450	\$ 450*	
ESOP (5-year distribution factor)	\$160,000	\$165,000	\$165,000*	
ESOP (account balance)	\$810,000	\$830,000	\$830,000*	
Taxable wage base ⁷	\$ 87,000	\$ 87,900	\$ 90,300*	
SECA tax for self-employed individuals, combined rate	15.3%	15.3%	15.3%	15.3%
Old-age, survivors, and disability insurance tax rate	12.4%	12.4%	12.4%	12.4%
Hospital insurance (Medicare)	2.9%	2.9%	2.9%	2.9%
Social Security tax for employees and employers, combined rate	7.65%	7.65%	7.65%	7.65%
Old-age, survivors, and disability insurance tax rate	6.20%	6.20%	6.20%	6.20%
Hospital insurance (Medicare)	1.45%	1.45%	1.45%	1.45%

Note: If not replaced by the OBRA '93 \$150,000 maximum compensation cap and then by the EGTRRA \$200,000 compensation cap for 2002, using the January 2004 CPI, the pre-1994 \$200,000 limit on plan compensation would have reached \$300,000 by 2005 (with \$10,000 rounding). Certain grandfathered governmental plans use the pre-1994 limit with \$5,000 rounding, resulting in a projected \$305,000 limit for 2005.

*Estimated limits.

¹ This number represents the catch-up limit available under Internal Revenue Code (IRC) Section 414(v). IRC Sections 457(b)(3) and 402(g)(8) provide separate catch-up rules that must also be considered in an appropriate situation.

² Defined-benefit limit applies to limitation years ending in indicated year.

³ *Defined-contribution limit* applies to limitation years ending in indicated year.

⁴ Compensation during the plan year beginning in the indicated year identifies highly compensated employees for the following plan year.

⁵ Generally, compensation during the determination year ending in the indicated year identifies key employees for the following plan year.

⁶ Compensation limit applies to plan years beginning in indicated year.

⁷ Calculation differs from CPI description provided above. Estimate reflects projection from the 2003 OASDI Trustees Report using high cost assumptions.

Source: Marjorie Martin, AON Consulting, Inc., Somerset, NJ. Prepared February 26, 2004.

ISBN 0-87051-601-9



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